WILLS AND ESTATE PLANNING

MATERIALS

ON

ESTATE PLANNING

2000-2001

Compiled by Bonnie Croll

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CHAPTER 1 - INTRODUCTION

1. ESTATE PLANNING

There is no universally accepted definition of estate planning. While, in general terms, it may be said to concern the orderly arrangement and disposition of a client's property, those who use the term differ as to the goals and purposes to be achieved and the emphasis which is to be given to each of them. In its widest sense, estate planning is synonymous with lifetime and testamentary financial planning and is directed at the accumulation of wealth, its disposition for the benefit of succeeding generations and, at all times, its protection from unnecessary erosion. In a more narrow sense the term is confined to plans for the disposition of property rather than to those which are aimed as well at its accumulation and preservation during the client's lifetime.

Within these two concepts there is room for considerable variation in emphasis. For some it is placed almost exclusively on tax planning with this concept either including or excluding the more subtle and artificial methods of keeping a client and his estate within the letter of the law. The identification of estate planning with ingenious tax avoidance devices, together, perhaps, with its use in commercial advertising has brought the name into disrepute in some quarters. [1]In recent years, however, it has been used increasingly to refer to a field of legal practice which is as old as the common law. This usage of the term and the precise significance it attributes to taxation is clearly described in the following passage:

> Estate planning is a current name for something which has always been done by the careful family lawyer: advising his clients as to arrangements for the most effective disposition of their capital and the income thereof.
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> The "*most effective disposition*" is the disposition which best suits the needs and personalities of the persons concerned and which is the most economical disposition. i.e.. with the least amount of shrinkage by reason of taxes and otherwise. If one strives for tax savings *per se*, the most effective disposition may or may not be achieved, because tax savings are almost always effected by some kind of irrevocable relinquishment which may or may not turn out to be desirable. Tax saving is but one of the elements of proper estate planning; much more than a knowledge of tax law is essential. Eagerness to produce tax saving has stimulated the use of ancient forms of transfer, such as trusts and powers of appointment, by persons who might not otherwise have used them and who are not always aware of the problems which they present. To discuss estate planning in a series of monographs on taxation tends to magnify the tax problem. It is important therefore (instead of indulging in the usual pious warning against over-emphasizing tax saving) to give adequate consideration to the many other equally important problems in estate planning.
>
> There are no standard solutions; no universal remedies, every case must receive the same special treatment which a patient expects from a physician.[2]

... A knowledge of tax law is an essential part of an estate planner's equipment but tax consequence should not be allowed to override or dominate the client's non-tax objectives. The crucial considerations must be the client's wishes with respect to the destination, apportionment and allocation of his property. The lawyer's role, in general terms, is to ascertain the wishes of the client as to the disposition of the estate and to ensure that he or she is aware of the extent and nature of the property which comprises it, of any contingencies which might affect his or her wishes with respect to its transmission, of the alternative methods by which those wishes might be implemented and of the consequences—revenue and otherwise—of each such method. When a plan has been approved by the client it will normally be the lawyer's responsibility to see that the legal requirements for its execution are complied with.

Revenue consequences will obviously have more importance for some clients than for others, but it would be a mistake to assume that they will have significance only in the case of large estates or for clients who are prepared, if not

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[1] "The expression 'estate planning' was invented about 30 years ago to promote sales of life insurance": Trachtman, "A credo for Estate Lawyers" (1961), 100 Trusts and Estates 871.

[2] Trachtman, *Estate Planning* (rev. ed. 1968), pp 1-2

anxious, to engage in sophisticated tax avoidance schemes. As long as there are taxation statutes which affect property, the flexibility of property law and the different modes of disposition it permits will make it inevitable that some types of disposition will attract more severe tax consequences than others. This is as much a fact in Canada as in jurisdictions which still collect gift and death taxes of the traditional kinds. By itself this provides an adequate answer to those who assert that estate planning in the particular sense which has been adopted here is a reprehensible exercise. Among practitioners and their clients there are vast differences of opinion as to the morality of attempts to avoid taxation by ingenious and often complex arrangements which, while offending the spirit of the revenue law, are designed to satisfy its letter.[3] Those who do not regard the prospect of failure or success as the only relevant criterion will often fail to agree on where the line should be drawn. Despite this lack of unanimity on the fringes it remains a fact that most of the taxation work in which Canadian estate planners are daily engaged is far removed from the kind of activity which has been described as "a cheap exercise in tax avoidance".[4]

In recent years, such schemes have received little encouragement from the judiciary and, with the enactment of the general anti-avoidance rule in section 245 of the *Income Tax Act* , they are even less likely to be successful.

However, until the unlikely event that it becomes obligatory for taxpayers to arrange their affairs so as to attract the maximum liability for taxation, advice with respect to taxation will be an essential and reputable function of the lawyer who is engaged in estate planning. It can hardly be questioned that, at the present day, a lawyer who attempts to assist clients to dispose of their property without a knowledge of, and a regard for, revenue consequences will be in breach of his or her professional obligations.[5]

2. GENERAL OBJECTIVES

An intestate estate is usually an unplanned estate and, although each of the Canadian provinces has laws which govern the distribution of property on an intestacy, there are certain obvious reasons why an individual should normally have a will. Quite apart from some archaic features, the relevant statutes are inevitably unsatisfactory because of the rigidity of the schemes they impose. An intestate estate will be distributed to persons whom the deceased may not have wished to benefit or may have wished to benefit in different proportions. Others whom the deceased might have preferred to benefit may be excluded. By making a will an individual can choose beneficiaries and the amounts each is to receive, provide for contingencies which may occur either before or after death,[6] separate the management from the enjoyment of property where this is deemed appropriate and, generally dictate the manner in which the estate is to be administered and its benefits allocated for a considerable period after the individual's death.

In the common law provinces no person will have any legal right or power to take possession of the property of an intestate until an application has been made to the court for a grant of letters of administration. (*Pursuant to changes to the New Estate Court Rules in Ontario, Letters Probate and Letters of Administration are now known as a Certificate of Appointment of Estate Trustee and an executor, administrator, or an administrator with will annexed is known as an Estate Trustee.*) For these purposes, administration bonds may be required, there may be disputes as to whom letters of administration may be granted, and in some cases the persons whom the deceased might have chosen will not be appointed. The appointment of an executor by will should avoid these difficulties. The executor's title will vest upon the death of the deceased and continuity of control over the estate should thereby be established in a person in whom the deceased had confidence and whose rights should be unquestionable. In particular cases, the impact of taxation on the estate may be affected substantially by a carefully drafted will.[7]

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[3] The differences are also reflected to a large extent in the attitudes of judges: see Bittker, B.I., *Professional Responsibility in Federal Tax Practice* (Federal Tax Press Inc., 1976); F.S.A. Wheatcroft "Ethical Restraints on Tax Practice in Great Britain", p. 327 at 334-335.

[4] Re *Weston's Settlements* [1969] I Ch. 223 at 227, per Stamp J.; affirmed [1969] 1 Ch. 234 (C.A.).

[5] Cf. *Farish v. Nat. Trust Co.,* [1975] 3 W.W.R. 499 (B.C.S.C.), particularly at 507 and 510

[6] The greatest flexibility can be obtained by the use of discretionary powers; see Chapter 4.

[7] And, conversely, the taxation consequences may destroy the whole dispositive scheme if the will is not drafted with sufficient care; see, for example, *Johnson v. M.N.R.* (1958), 58 D.T.C. 592 (T.A.B.).

If the composition and execution of a will can be regarded as almost the irreducible minimum of estate planning, it will not be sufficient for many clients. Some will wish to retain full ownership and control of their estates until their deaths; others will wish to dispose of part of their property in their lifetimes for the benefit of their spouses or descendants or in support of philanthropic activities...

Developments in matrimonial property law in the common law provinces have introduced a new element to be considered when drafting wills, and the practice of supplementing a will with a domestic contract is becoming increasingly common.

The main responsibilities of the lawyer in estate planning have been outlined above but it must be stressed that they are not confined to ascertaining the client's wishes and then implementing them by the method which will attract the smallest liability in tax. At the first interview many clients will have only the most sketchy idea of how they wish to dispose of their estates. Few will have thought of all the contingencies which should be provided for and some will lack a full appreciation of the extent or value of their property. It follows that, in taking instructions, the experienced lawyer will rarely play a passive role. Although the lawyer will be concerned entirely to ascertain the wishes of the client he or she may have a highly significant part to play in their evolution. For that purpose a knowledge of the limits on the freedom of testamentary disposition which are imposed by the general law and by statutes, such as those that confer rights upon surviving spouses or relief for other dependants, will be often relevant.

Even the simplest form of estate planning cannot be viewed as a mechanical exercise. Individuals in similar financial circumstances may differ widely in their attitudes towards their property and their families. The dispositive wishes of clients with estates of moderate size will sometimes require more elaborate wills than those of wealthier individuals. Some clients will be happy to relinquish ownership and control of their assets while relatively young and in good health. Others, for a variety of reasons, will wish to retain ownership or control until death.

When a plan or alternative plans are placed before the client, it is part of the lawyer's responsibility to see that they are properly understood and their implications fully appreciated. There are many reported cases which illustrate the consequences of a failure to discharge this obligation. If a taxpayer's objection to an assessment is based on the intention with which particular acts were done he or she will be in obvious difficulty if unable to state and explain what was intended.

After a plan has been chosen great care must be taken to ensure that it is implemented in a way that is beyond legal challenge. If there have been many cases of wills and trusts instruments which have been drafted with due care and expertise in all respects other than their tax implications, there have also been many in which tax planning by specialists has been frustrated by inadequate attention to the requirements of the general law.

Where an estate is large or complex the formulation of possible plans of disposition may require the use of the services of knowledgeable professionals in other fields. The relationship between their functions and those of the lawyer has been described as follows:

> As the problems of estate planning increase in complexity, in fluctuation, and in number, the need and opportunity may arise for specialization to a degree not possible for the average solicitor, so that other expert services will be necessary. Estate planning has sometimes been described as the work of a team, which may comprise a life insurance underwriter, an accountant, an investment counsel, a valuator, a trust officer, and, finally, a lawyer. Though each of these other vocations is vested with special knowledge or competence to assist in estate planning, none of them is in a position to carry out estate planning properly single-handed. Life underwriters are in the field because they have something to sell. Their form of estate planning is attractive because there is no direct charge for it; but there is little to merit their entry into the field of estate planning beyond advising on the types of insurance and their possible uses. The same observation is applicable to other groups mentioned. The accountant is favourably situated in that his work takes him closely into the client's business affairs from which position he can assess the need for a plan, can impress his client with the dangers of neglecting to plan, and can stimulate his interest in doing something about it. Advice from any source in regard to estate planning and particularly the taxation aspect of it, cannot be properly undertaken except by someone trained in knowing the full legal significance of every step that must be taken in implementing the advice.
>
> The lawyer who does not wish to develop the skills and abilities of these other vocations nevertheless has an important service that he can and should render. He can select or recommend these experts, judge their competence, supervise and revise their work, and weigh the practical wisdom of

> suggestions they may make. Finally, he can insist on his position of independence in giving his client advice in relation to any aspect of it
> . . . The responsibility for estate planning rests ultimately on the lawyer whose position as independent adviser, charging on a straight fee basis for time spent and advice given, renders him best suited to this important function that has traditionally belonged to his profession.[9]

In particular, it must be emphasized that, despite the lamentable attempts in recent years to reduce the provisions of the *Income Tax Act* [10] to a series of quasi-mathematical formulae, the task of interpreting a taxing statute is properly that of a person with legal training. Of necessity, such statutes are built upon a foundation of private law concepts, rules and institutions. No professional should be regarded as qualified to give tax advice, and much less advice on estate planning generally, to the public unless such professional has a sound knowledge of the law relating to corporations, trusts, partnerships and of the general principles of commercial and property law, including the law of wills. Although there are undoubtedly accountants and others who have acquired such knowledge and who are skilled tax practitioners in every sense, the importance of a formal training in law cannot be overemphasized.

It is also important to stress that the responsibility of the lawyer to see that an estate plan is properly implemented cannot be delegated to other professionals, however valuable their contribution to the formulation of the plan may have been. This requires an attention to the substantive requirements and formalities for particular kinds of dispositions and methods of holding property, to the order in which dispositions and other transactions are effected and to proper documentation.

In cases where attempts at estate planning subsequently encounter problems with Revenue Canada or other taxation authorities, the legal practitioner should be uniquely qualified to conduct any necessary negotiations or appeals.

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[9] La Brie, "Estate Planning" (1964), 3 Alta. L Rev. 225 at 227

[10] R.S.C. 1952, c. 148 as amended by S.C. 1970-71-72, c. 63 and more recent statutes.

Glossary of Terms

Beneficiary	In general, the person receiving or designated to receive a benefit or advantage. 1. the person named in a **will** to receive property under the will. 2. The person having the beneficial enjoyment of property rather than the legal possession - for example, the person for the benefit of whom a **trust** is created or, in other words, the CESTUI QUE TRUST in a trust relationship.
Personal representative	The executor or administrator of a deceased person, known under the new Ontario legislation as *Estate Trustee.*
Intestate	To die without a will. A person is said to die intestate when he or she dies without making a will, or dies without leaving anything to testify what his or her wishes were with respect to the disposal of his or her property after his or her death. Under such circumstances, provincial law prescribes who will receive the decedent's property. The laws of intestate succession generally favour the surviving spouse, children and grandchildren and then move to parents and grandparents and to brothers and sisters. The word is also often used to signify the person himself or herself. Thus, in speaking of the property of a person who died intestate, it is common to say "the intestate's property," *i.e.*, the property of the person dying in an intestate condition. *Compare* Testate.
Testate	To die leaving a will.
Testator/Testatrix	One who has made a will; one who dies leaving a will.

CHAPTER 2 - THE POSITION OF THE PERSONAL REPRESENTATIVE

Duties of the Personal Representative

The responsibility for addressing the tax consequence of a taxpayer's death is, logically enough, placed upon the personal representative.[20] However, the ITA does not simply place the responsibility on the personal representative's shoulders: it imposes *personal liability* [21] for failing to discharge it. The imposition of this personal liability is obviously an important consideration for a personal representative, and is therefore worthy of some careful explanation.

Under provincial common and statute law, a creditor, including a creditor such as Revenue Canada, can pursue its claim against the beneficiary who has received funds from the estate, since the right of a creditor to be paid in full takes priority over the right of a beneficiary to receive a gift. The ITA does not dilute this principle: Revenue Canada is as free as any other creditor to seek payment from beneficiaries to the extent that they have benefited from the estate in preference to creditors.

Provincial law also states that a personal representative can be held personally liable for creditors' claims if he or she has distributed property to beneficiaries when he or she knew or ought to have known of creditors' claims.[22] It provides a scheme for the personal representative to follow if he or she wishes to avoid such a personal liability,[23] and provides a further scheme for establishing priorities among creditors.[24] Again, Revenue Canada can avail itself of all of these rules.

The ITA gives Revenue Canada a very substantial additional protection. It states that a personal representative, before distributing[25] any property under his or her control, must obtain a certificate certifying that taxes, interest and penalties have been paid in respect of the taxation year in which the distribution is made, in respect of a preceding taxation year, and in respect of a payment to Revenue Canada for which the personal representative can reasonably be expected to become liable".[26] Failure to obtain the certificate is not a punishable offense akin to tax fraud, but it carries with it a risk. Where a personal representative distributes property without obtaining the requisite certificate, the personal representative becomes personally liable for the payment of those amounts to the extent of the value of the property distributed.[27]

A clearance certificate is an additional document that is applied for by the personal representative,[28] after the tax returns for the period to be covered by the certificate have been assessed. Mercifully, in respect of the final distribution clearance certificate, the personal representative is not required to estimate how long he or she thinks that it will take

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[20] Section 150(3)

[21] Section 159(2), (3); IT-282R, IC82-6

[22] *Williams, Mortimer and Sunnucks on Executors, Adinistrators and Probate*, page 599

[23] *Trustee Act,* R.S.O. 1990, c T.23, s.53 (advertising for creditors)

[24] The *Trustee Act*, s.50, states that creditors, including the Crown, are payable *pro rata.* This provincial law does not bind the federal Crown. The ITA (s.222) makes an unpaid income tax liability a debt due to the Crown. The Crown has a common law prerogative to be paid in priority to ordinary creditors. This has the effect of giving federal income tax liabilities a priority over the provincial crown and ordinary credtors. There are other enforcement provisions in the ITA that may be used to give Revenue Canada an effective priority (such as the "third party demand provisions" in s.224). A personal representative or creditor can also invoke the operation of the federal *Bankruptcy* Act.

[25] the word "distribute" does not appear to have been judicially interpreted in the context of s.159; it could refer to "any payment", "any payment to a beneficiary or creditor that is not a testamentary expense (an expense necessarily incurred in order to administer the estate and recognized by provincial law as having a priority over payments to general creditors)", or "any payment to a beneficiary". The former is surely not correct; is a personal representative supposed to obtain Revenue Canada's permission to pay a funeral bill? As between the second and third possibilities, one wonders whether such a vaguely worded provision as s.159 could be said to create a substantive right or, constitutionally, to be a necessary incident of a taxation scheme that would otherwise override a clearly defined set of rules under provincial law.

[26] Section 159(2)

[27] Section 159(3).

[28] Form TX19.

Revenue Canada to issue the clearance certificate, and to file a return with income estimated to that future date; instead, when ready, except for settling tax matters, to effect the final winding up of an estate and the distribution of any remaining assets to the beneficiaries, he or she calculates income earned to a past date and undertakes to distribute the estate promptly upon receipt of that certificate. Income earned by the estate during the hiatus period between the date so selected and the time when the clearance certificate arrives is regarded for tax purposes as earned by the personal representative as agent for the beneficiaries.

The effect of the personal liability provision is, crudely put, to terrorize personal representatives into ensuring that they do not overlook their obligation to file tax returns on behalf of an estate that they might otherwise be able to distribute without doing so; and to provide Revenue Canada with a direct source for the payment of tax.

If one were to take those provisions of the ITA at face value, and if one were to be consulted by a personal representative who wished to avoid personal liability, one would be required to advise the personal representative to settle the deceased taxpayer's estate at a rate determined entirely by the speed of the assessment and audit process of Revenue Canada. However, if one were to conduct oneself in this manner, one would in all likelihood be able to enjoy a skate in Hades before the estate was fully distributed. In short, it is theoretically attractive, but practically impossible, to administer an estate on this basis. Instead, most personal representatives, knowingly or unknowingly, assume the personal liability described above by making interim distributions and, if they are professionally advised, retain a reserve to meet and exceed anticipated taxes, and do not distribute the reserve until the clearance certificate is in hand.[29]

It is not unheard of for clients to remark that their former lawyer never advised them of the personal liability provisions of the ITA; that had they heard of them, they would not have distributed the estate as rapidly as they did; that the beneficiaries do not appear willing voluntarily to return the necessary funds to pay the tax; that Revenue Canada seems content to collect the tax from the personal representative and is not passionately interested in the equities of the argument that it should collect from the beneficiaries pro rata; and that their former lawyer who has no memory or notes to verify whether the subject was ever discussed, should perhaps be sued for professional negligence.

There is a separate reason to apply for a clearance certificate. Revenue Canada has the right to reassess a tax return at any time if there has been fraud or neglect, but otherwise for three years after the expiry of the normal annual assessment period.[30] A personal representative will wish to have distributed the estate before the expiry of the period during which reassessment is a possibility, but , especially if he or she is not a beneficiary, will not wish to carry the contingent risk of personal liability that might arise from any such reassessment. The clearance certificate operates as a representation to the personal representative by Revenue Canada that, notwithstanding that the deceased's tax returns might in the future be reassessed, no liability will attach to the personal representative from the reassessment.[31] Recent jurisprudence has made it clear, however,[32] that the issuance of a clearance certificate does not operate to prevent Revenue Canada from reassessing a return after its issuance and seeking the taxes that are due from the beneficiaries.

None of the foregoing should lead the reader to the conclusion that it is either mandatory or appropriate in every case to obtain a clearance certificate. An estate can be distributed without the certificate. A personal representative who is also the sole beneficiary of the estate has no particular reason to seek a discharge from personal liability in his or her capacity as a personal representative, when he or she would remain personally liable in any event in his or her capacity as a beneficiary. The only purpose for obtaining a clearance certificate in that circumstance would be to obtain "virtual certainty" that no reassessment of the deceased's taxes will be conducted. Many, even most, taxpayers are content to run the risk of future reassessment because they are satisfied that the deceased's tax affairs are in good order. In addition, the request for a clearance certificate essentially operates as a request to the audit staff of Revenue Canada to take a closer look for what the

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[29] As an alternative, if a personal representative is on good terms with the beneficiaries (and considers them to be solvent), he or she may be prepared to distribute the entire estate prior to the receipt of a clearance certificate and to accept the undertaking of the beneficiaries to indemnify the personal representatives to the extent that the personal representative is subsequently found to be liable for additional tax.

[30] Section 152(4)

[31] In practical terms, the issuance of a clearance certificate also provides the beneficiaries with a strong indication that the deceased's tax business will never be reopened.

[32] *Bougie Estate v. The Queen*, 90 D.T.C. 6529; *Bouger Estate v. M.N.R.*, 89 D.T.C. 15.

original assessment might have missed. In some circumstances, it may be better not to invite a taxing authority to take a second kick at the cat but rather (to mix metaphors) to let a sleeping dog lie.

CHAPTER 5 - SPOUSE TRUST

Income of Spouse Trust

1. "*Entitled to all of the income*"

In determining whether the spouse is entitled to receive all of the income of the trust that arises during his or her lifetime, the Act provides that, subject to specific exceptions, the income of a trust is its income computed without reference to the provisions of the Act.[53]

Calculation of income amounts would therefore presumably conform to the requirements of equity and trust law. It follows that income computed using these rules will produce a different result than would income calculated for tax purposes. Most obviously, stock dividends and taxable capital gains may give rise to tax liability as a result of income generated but would not be income to which the spouse must be entitled.

One of the specific statutory exceptions in computing trust income for this purpose is tax-free capital dividends. Thus, a trustee may be empowered to accumulate these without infringing the requirement that the deceased's spouse must be entitled to receive all of the income of the trust. Similarly a direction that stock dividends may be accumulated at the trustee's discretion may, depending on the type of dividend, not infringe subparagraph 70(6)(b)(i) or (ii). Consequently, a trust will not be precluded from qualifying as a spouse trust if, under the terms of the trust, such dividends are not paid or payable to the spouse. As well, amounts such as taxable capital gains which were neither paid nor payable to the spouse under the terms of the trust nor included in the spouse's income under a preferred beneficiary election but which gave rise to taxable income may be taxed in the trust. (For taxation years 1996 and following, preferred beneficiary elections will not be available except with respect to certain mentally or physically impaired beneficiaries)

By virtue of subsection 108(4), a trust is considered to be a spouse trust even though it is charged with payment of any income or profits tax in respect of any of its income for the purposes of the Act, or any estate, legacy, succession or inheritance duty payable in consequence of the testator's death in respect of any property of the trust or any income or capital interest in it.

Two Departmental concessions are also provided in determining whether the spouse is entitled to receive all of the income. First, if the will of the decedent provides for the establishment of the trust from the residual assets of the estate, the fact that income derived from the assets prior to the vesting in the trust is used to pay specific bequests or other testamentary debts will not preclude the trust from qualifying as a spouse trust. Second, the Department applies the doctrine of constructive receipt in interpreting the requirement that the spouse must be entitled to receive all of the income of the trust that arises before her or his death. As a result, a provision in a will for the payment of any income of the trust to a person other than the spouse, on the condition that it be used solely for the benefit of the spouse, does not disqualify an otherwise qualifying spouse trust.

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[53] Subs. 108(3)

Income of Trust s.108(3) - ITA

(3) **Income of a trust in certain provisions** — For the purposes of the definition "income interest" in subsection (1), the income of a trust is its income computed without reference to the provisions of this Act and, for the purposes of the definition "pre-1972 spousal trust" in subsection (1) and paragraphs 70(6)(b) and (6.1)(b), 73(1)(c) and 104(4)(a), the income of a trust is its income computed without reference to the provisions of this Act, minus any dividends included therein

(a) that are amounts not included by reason of section 83 in computing the income of the trust for the purposes of the other provisions of this Act;
(b) that are described in subsection 131(1); or
(c) to which subsection 131(1) applies by reason of subsection 130(2).

No Disqualification of Spousal Trust s.108(4) - ITA

(4) **Trust not disqualified** — For the purposes of the definition "pre-1972 spousal trust" in subsection (1) and subparagraphs 70(6)(b)(ii) and (6.1)(b)(ii), 73(1)(c)(ii) and 104(4)(a)(iv), where a trust was created by a taxpayer whether by the taxpayer's will or otherwise, a person, other than the taxpayer's spouse, shall be deemed not to have received or otherwise obtained or to be entitled to receive or otherwise obtain the use of any income or capital of the trust solely because of the payment, or provision for payment, as the case may be, by the trust of

(a) any estate, legacy, succession or inheritance duty payable, in consequence of the taxpayer's death, in respect of any property of, or interest in, the trust; or
(b) any income or profits tax payable by the trust in respect of any income of the trust.

Occurrences as a Consequence of Death s. 248(8) -ITA

(8) **Occurrences as a consequence of death** — For the purpose of this Act,

(a) a transfer, distribution or acquisition of property under or as a consequence of the terms of the will or other testamentary instrument of a taxpayer or the taxpayer's spouse or as a consequence of the law governing the intestacy of a taxpayer or the taxpayer's spouse shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer or the taxpayer's spouse, as the case may be;
(b) a transfer, distribution or acquisition of property as a consequence of a disclaimer, release or surrender by a person who was a beneficiary under the will or other testamentary instrument or on the intestacy of a taxpayer or the taxpayer's spouse shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer or the taxpayer's spouse, as the case may be; and
(c) a release or surrender by a beneficiary under the will or other testamentary instrument or on the intestacy of a taxpayer with respect to any property that was property of the taxpayer immediately before the taxpayer's death shall be considered not to be a disposition of the property by the beneficiary.

♦s. 248(9)♦

(9) **Definitions** — In subsection (8),

"disclaimer" — "disclaimer" includes a renunciation of a succession made under the laws of the Province of Quebec that is not made in favour of any person, but does not include any disclaimer made after the period ending 36 months after the death of the taxpayer unless written application therefor has been made to the Minister by the taxpayer's legal representative within that period and the disclaimer is made within such longer period as the Minister considers reasonable in the circumstances;

"release or surrender" — "release or surrender" means

(a) a release or surrender made under the laws of a province (other than the Province of Quebec) that does not direct in any manner who is entitled to benefit therefrom, or

(b) a gift inter vivos made under the laws of the Province of Quebec of an interest in, or right to property of, a succession that is made to the person or persons who would have benefited if the donor had made a renunciation of the succession that was not made in favour of any person,

and that is made within the period ending 36 months after the death of the taxpayer or, where written application therefor has been made to the Minister by the taxpayer's legal representative within that period, within such longer period as the Minister considers reasonable in the circumstances.

Overview - Transfer As A Consequence Of Death

Subsection 248(8) provides an expanded definition of transfers of property "as a consequence of the death" of a taxpayer. This provision is relevant for the definition of testamentary trust and for the intergenerational rollovers of farm property and shares of a small business corporation where the transfer was made as a consequence of the death of a taxpayer as provided by section 70.

Prior to the enactment of subsection 248(8) there was a concern that the section 70 rollover provisions would not apply where consideration was paid by the beneficiary to the estate in satisfaction of the terms of a testamentary instrument since in these circumstances the transfer may result from the payment of consideration rather than being made as a consequence of the death of the testator. Paragraph 248(8) (a) provides clarification and ensures that the section 70 rollovers will be available in these circumstances.

Paragraph 248(8)(b) ensures that provisions currently applicable to transfers or dispositions made as a consequence of death will also apply to those made as a consequence of a disclaimer, release or surrender by a person who was a beneficiary under the taxpayer's will or intestacy. These latter types of transfers are considered to be transfers made as a consequence of death.

Paragraph 248(8)(c) provides that the release or surrender by the beneficiary will not be considered to be a disposition of the property by the beneficiary.

Subsection 248(9) defines the terms used in subsection 248(8). It also limits the releases and surrenders referred to in subsection 248(8) to those:

(a) that are not made in favour of any particular person or persons; and

(b) that are made within three years of the taxpayer's death or such longer period as the Minister, on written application therefor, considers reasonable.

Related amendments to the various rollover provisions contained in section 70 provide that the property must vest indefeasibly within the period described above to qualify for the rollover treatment.

Interpretation Bulletin IT-305R4 - Testamentary Spouse

Date: October 30, 1996

Reference: Subsections 70(6), (6.1), (7) and (8) (also subsections 12(10.2), 70(5), (5.4) and (6.2), 108(3) and (4), 248(3), (8), (9), (9.1) and (9.2) and 252(3) and (4) and paragraph 5 of Article XXIXB of the Canada-United States Income Tax Convention (1980))

Application

This bulletin replaces and cancels Interpretation Bulletin IT-305R3, *Establishment of Testamentary Spouse Trust*, dated June 29, 1987. It also incorporates relevant comments from Interpretation Bulletin IT-207R, *"Tainted" Spouse Trusts* , dated March 26, 1979 and cancels that bulletin.

Summary

The purpose of subsection 70(6) is to allow a deferral of the tax consequences that would otherwise arise from the deemed dispositions of capital property occurring as a result of a taxpayer's death, if the property is transferred or distributed to the taxpayer's spouse or to a testamentary trust established in favour of the spouse and the other requirements of that provision are met.

This bulletin discusses the conditions which must be met for a trust to qualify as a spouse trust described in subsection 70(6) and the situations under which such a trust becomes "tainted." It also discusses the tax implications of a tainted spouse trust and how, if at all, a tainted spouse trust can be "untainted." Finally, the bulletin discusses a similar deferral, under subsection 70(6.1), of what would otherwise be the tax consequences of the deemed payments out of a NISA Fund No. 2 occurring as a result of death.

Discussion and Interpretation

General

1. Taxable capital gains, allowable capital losses, recaptures of capital cost allowance and terminal losses which would otherwise arise as a result of a taxpayer's death, by virtue of the deemed disposition of capital property under subsection 70(5), are generally deferred if, as a consequence of the taxpayer's death (see 9 to 12 below), the property is transferred or distributed to the taxpayer's spouse or to a trust established in favour of the taxpayer's spouse as described in subsection 70(6) (a "spouse trust").

2. When subsection 70(6) applies, the spouse or spouse trust which acquires a capital property as a consequence of the taxpayer's death generally assumes the taxpayer's tax cost of the property. This amount is also the deceased's proceeds of disposition of the property. The deceased taxpayer's legal representative may, however, elect under subsection 70(6.2) to have subsection 70(5), rather than subsection 70(6), apply to any capital property of the taxpayer. In these circumstances, the proceeds of disposition of the property to the deceased and its cost to the spouse or spouse trust are each equal to the fair market value of the property immediately before death. An election made under subsection 70(6.2) must be made in the deceased's regular income tax return for the year of death.

3. When a partnership interest of a deceased taxpayer is transferred or distributed to the taxpayer's spouse or to a spouse trust, as described in subsection 70(6), and the taxpayer's adjusted cost base of the interest was negative immediately before death, subsection 70(6) may not result in a complete tax-deferred transfer or distribution. For more information, see the current version of IT-278, *Death of a Partner or of a Retired Partner.*

4. By virtue of subsection 252(3), a taxpayer's spouse includes, for purposes of subsection 70(6), an individual of the opposite sex who is party to a voidable or void marriage with the taxpayer. Furthermore, subsection 252(4) extends the meaning of spouse, for purposes of the Act, to include what is generally referred to as a "common-law spouse."

Establishment of Testamentary Spouse Trust

5. A spouse trust, as described in subsection 70(6), is created by a taxpayer's will (see 11 and 12 below) and must entitle the spouse to receive all the income of the trust arising before the spouse's death. Furthermore, no one but the spouse may receive or otherwise obtain the use of any of the trust's income or capital before the spouse's death (see also 13 to 16 below). For subsection 70(6) to apply, the capital property transferred or distributed to the spouse or spouse trust must vest indefeasibly in the spouse or spouse trust within 36 months of the taxpayer's death or, upon written application to the Minister within that period, within such longer period as the Minister considers reasonable in the circumstances. In addition, by virtue of subsection 248(9.2), the property must vest indefeasibly in the spouse or spouse trust before the spouse's death. For information on the term "vest indefeasibly," see the current version of IT-449, *Meaning of "Vested Indefeasibly."*

6. For a testamentary trust to qualify as a spouse trust under subsection 70(6), the deceased must have been resident in Canada immediately before death and the trust created by the deceased's will must be resident in Canada immediately after the time the property vested indefeasibly in the trust.

7. An executor may have the discretion as to which properties are to be transferred to the spouse trust with the will specifying only the total value of the property or portion of the estate to be so transferred. The will may also provide for the establishment of more than one trust (for example, a spouse trust and a family trust) and specify the total value of property to be transferred to each trust while leaving to the executor's discretion the selection of specific property to be transferred to each trust. In other instances, the will may direct the establishment and terms of a spouse trust but leave total discretion to the executor to select both the total value of and property to be transferred to the trust. In the absence of any express directions in the will, the executor is governed by the law of the relevant jurisdiction in allocating the property of the estate to the various beneficiaries and trusts. These kinds of arrangements do not disqualify a trust otherwise qualifying as a spouse trust.

8. Once a trust qualifies as a spouse trust under the terms of subsection 70(6), it remains a spouse trust and is subject to the provisions affecting such trusts (for example, paragraph 104(4)(a)) even if its terms are varied by agreement, legal action or breach of trust. However, these events may cause other provisions of the Act to apply, such as paragraph 104(6)(b) and subsections 106(2) and 107(4).

Transfer or Distribution as a Consequence of Death and Trust Created by Will

9. By virtue of subsection 248(8), a property is considered to have been transferred or distributed to, and acquired by, a spouse or spouse trust as a consequence of a taxpayer's death when the transfer, distribution or acquisition was:

(a) under, or as a consequence of, the terms of the will or other testamentary instrument of the taxpayer,
(b) as a consequence of the law governing the intestacy of the taxpayer, or
(c) as a consequence of a disclaimer, release or surrender (see 10 below) by a beneficiary under the will or other testamentary instrument or on the intestacy of the taxpayer.

10. Subsection 248(9) describes "disclaimer" and "release or surrender" for the purposes of subsection 248(8). A disclaimer involves an outright refusal to accept a gift, share or interest under a will, with no stipulation as to how the taxpayer's legal representatives should distribute the disclaimed property. A disclaimer of property in favour of another person is not a true disclaimer but an assignment. However, when such a disclaimer or assignment would achieve the same effect as a simple disclaimer without any assignment, a disclaimer is considered to have been made for the purposes of subsection 70(6). In Quebec a disclaimer includes a renunciation of a succession made under the laws of that province that is not made in favour of any person. For subsection 70(6) to apply, a disclaimer must be made within 36 months of the taxpayer's death or, upon written application to the Minister within that period, within such longer period as the Minister considers reasonable in the circumstances.

A release or surrender made under the laws of a province (other than the Province of Quebec) must not be in favour of a particular person. For the Province of Quebec, a release or surrender means an *inter vivos* gift of an interest in, or right to property of, a succession made to the person who would have benefited had the donor renounced the succession but not in favour of anyone. A release or surrender, whether made within the Province of Quebec or otherwise, must be made within the same time as a disclaimer is made, as described above.

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12. Whether or not a trust was created by a taxpayer's will, subsection 248(9.1) recognizes that a qualifying spouse trust may be established by a court order, in relation to the taxpayer's estate, made under any law of a province that provides for the relief or support of dependants. A similar result may not be achieved by a variation made by agreement among the beneficiaries, even under variation of trusts legislation since such a trust is not created as a consequence of death within the meaning of subsection 248(8).

Requirements regarding the Income and Capital of a Spouse Trust

13. As indicated in 5 above, to qualify as a spouse trust, the spouse must be entitled to receive all the income of the trust arising before the spouse's death and no one but the spouse may receive or otherwise obtain the use of any of the income or capital of the trust before the spouse's death. For this purpose, subsection 108(3) provides that the income of the trust is its income calculated under trust rules (rather than in accordance with the Act) less any dividends included therein:

(a) that are not included in computing the trust's income, for other purposes of the Act, by reason of section 83,
(b) that are described in subsection 131(1), or
(c) to which subsection 131(1) applies by reason of subsection 130(2).

Consequently, a trust will not be precluded from qualifying as a spouse trust because of the fact that, under the terms of the trust, such dividends are not paid or payable to the spouse. Also, amounts such as taxable capital gains (that are not in the nature of income under trust rules) which were neither paid nor payable to the spouse under the terms of the trust, nor included in the spouse's income under a preferred beneficiary election, are necessarily taxed in the trust, since during the spouse's lifetime no one but the spouse may receive anything out of a qualifying spouse trust or make a preferred beneficiary election in connection with the trust's income.

14. Under subsection 108(4), a trust is not prevented from qualifying as a spouse trust solely because it is charged with the payment of

(a) any income or profits tax on any of its income computed in accordance with the Act, or
(b) any estate, legacy, succession or inheritance duty payable in consequence of the testator's death on any property of the trust or any income or capital interest in it.

15. In interpreting the requirement that the spouse must be entitled to receive all of the income of the trust that arises before the spouse's death, the doctrine of constructive receipt is applied. Consequently, the payment according to the will of, or the provision in the will for the payment of, any income of the trust to a person other than the spouse, on the condition that it be used solely for the benefit of the spouse, does not disqualify an otherwise qualifying spouse trust.

16. In interpreting the requirement that no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust, the renting of real estate at market value or the lending of money on commercial terms (including market rates of interest, appropriate securities and a reasonable repayment schedule), does not generally mean that the person renting the real estate or borrowing the money has received or has the use of that property as the term is used in this requirement.

"Tainted" Spouse Trust

17. A trust created by a taxpayer's will in favour of a spouse that does not meet the qualifications of a spouse trust set out in subsection 70(6) is commonly referred to as a "tainted" spouse trust. One cause of a spouse trust being tainted is a direction in the will to pay out of the trust various debts, obligations or death duties, other than those to which subsection 108(4) applies (see 14 above).

18. Subsection 70(7) provides a method for untainting some types of tainted spouse trusts, thus permitting the rollover provided by subsection 70(6). This is possible when the debts, obligations and death duties referred to in 17 above are "testamentary debts" and the trust otherwise qualifies as a spouse trust. The term "testamentary debt," which is defined in paragraph 70(8)(c), means:

(a) any debt of the taxpayer, or any other obligation of the taxpayer to pay an amount, that was outstanding immediately before his or her death, and

(b) any amount payable by the estate in consequence of the taxpayer's death, other than any amount payable to any person as a beneficiary of the estate,

including income or profits tax payable by or for the taxpayer for the taxation year in which he or she died and for any previous taxation year, and any estate, legacy, succession or inheritance duty payable in consequence of the taxpayer's death.

Testamentary debts also include funeral and testamentary expenses and compensation to representatives for carrying out those duties which are normally exercised by an executor or administrator, that is, up to the point the estate properties are transferred or distributed to the beneficiaries or to the trustee of the tainted spouse trust or any other trust arising on death.

19. A trust for the benefit of a spouse is tainted in a manner that cannot be remedied by the method provided in subsection 70(7) if certain types of obligations are to be met out of its property before the death of the spouse. Examples of such obligations include:

(a) a contingent liability to make good any deficiency that may arise in another trust created under the same will,
(b) a liability for the payment of trustee fees applicable to other trusts under the will,
(c) an obligation to pay a bequest to another beneficiary out of the property of the estate that is held by the spouse trust, and
(d) a remarriage clause which, if the spouse remarries, would result in someone other than the spouse being entitled to income or capital of the trust before the spouse's death.

The trust is not tainted in this manner, however, if the debt or obligation to be met is:

(e) a testamentary debt (see 18 above),
(f) a debt or obligation to the spouse,
(g) a debt or obligation incurred for the benefit of the spouse, or
(h) an obligation to pay fees to the trustee for the administration of the spouse trust.

CHAPTER 6 - CAPITAL PROPERTY OWNED AT DEATH - OTHER RELIEVING PROVISIONS

Principal Residence Exemption

(e) Principal Residence

A principal residence is given special treatment under the capital gains provisions of the Act.[117] The term "principal residence" is defined in paragraph 54(g) and, in general terms, is a housing unit which is owned by the taxpayer, alone or jointly, and ordinarily inhabited in the year by the taxpayer, the taxpayer's spouse or former spouse or dependent child. The property must be designated as a principal residence in the year it is disposed of and no person can designate more than one principal residence for any year.[118]

As a principal residence is a personal-use property, capital losses will not be realized on its disposition.[119] Any taxable capital gain will be reduced according to the number of years in which the property was the taxpayer's principal residence in the period in which the taxpayer was its owner. The amount of any gain is calculated as follows:

$$\begin{pmatrix}\text{Gain}\\ \text{otherwise}\\ \text{determined}\end{pmatrix} - \left[\begin{pmatrix}\text{Gain}\\ \text{otherwise}\\ \text{determined}\end{pmatrix} \times \left(\frac{\text{1 + number of years principal residence}}{\text{number of years owned}}\right)\right]^{120}$$

If for example, a house was bought in 1986 for $50,000, sold in 1991 for $80,000 and occupied as a principal residence over the entire period, no gain would arise from its disposition.[121] If it had been a principal residence for only two of the six years the gain would be $15,000.

On the death of a taxpayer, the taxpayer's principal residence, like his or her other capital properties, will be deemed to have been disposed of and the amount of the deemed proceeds will depend upon whether subsection 70(5) or (6) is applicable. If subsection 70(5) applies any gain will be computed in the same way as if the property had been disposed of during the taxpayer's life. If subsection 70(6) applies, the spouse or spouse trust will acquire the property at a cost equal to its adjusted cost base and no gain will be realized.[123] In order to ensure that no gain attributable to a period in which the property was the principal residence of the deceased will arise when the spouse or the trust subsequently disposes of it, it is provided that the spouse or trust shall be deemed to have owned the property for each year in which it was owned by the deceased, to have occupied it as a principal residence for each year in which it was the deceased's principal residence and, in the case of a spouse trust, to have been resident in Canada in each year in which the deceased was resident in Canada.[124]

Thus, in the above example, if the deceased died in 1989 and the property vested absolutely in the surviving spouse who sold the property two years later without having ordinarily inhabited it since the deceased's death, the gain would be computed as follows:

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[117] See Interpretation Bulletin IT-120R3, February 16, 1984, "Principal Residence", as revised by Correction Sheet dated November 22, 1985; for a review of the legislative history of the special treatment, see Harris, "A Case Study in Tax Reform: The Principal Residence" (1983), 7 Dalhousie Law Journal 169.

[118] Subpara. 54(g)(iii).

[119] Subpara. 40(2)(g)(iii).

[120] The formula is designed to prevent any portion of the gain from being taxable if it was always used as a principal residence.

[121] $(\$80{,}000 - \$50{,}000) - \left[30{,}000\left(\frac{1+6}{6}\right)\right] = \text{nil}$; $(\$80{,}000 - \$50{,}000) - \left[30{,}000\left(\frac{1+2}{6}\right)\right] = \$15{,}000$

[123] It may be preferable to elect under subs. 70(6.2) to not roll the principal residence over to the spouse. This would allow for a bump up in the cost base of the principal residence to the spouse without adverse tax consequence to the deceased.

[124] Subs. 40(4). See Interpretation Bulletin IT-366R, May 4, 1984, "Principal Residence—Transfer to Spouse, Spouse Trust or Certain Other Individuals" (as amended by SR-1987, paras. 8 and 10

$$\text{Gain} = \$30,000 - \left[30,000 \times \frac{1+4}{6}\right] = \$5,000$$

If the property had been the principal residence of the spouse during either or both of two years following the deceased's death, no gain would arise from the disposition.

Where the successor is a spouse trust, the spouse or the spouse's dependent child is required to have ordinarily inhabited the property for the purpose of subparagraph 54(g)(i) and the designation as a principal residence must be made by the spouse.[125] If these requirements are satisfied, the property will be the principal residence of the spouse trust and any gain on the death of the spouse or on an earlier disposition will be calculated in the same way as if the trust had owned the property during the period in which it was owned by the deceased and as if it had been the principal residence of both the spouse and the spouse trust throughout the period in which it was that of the deceased.[126] Once again, no gains will arise if the deceased occupied the property as his or her principal residence in every year after acquiring it and the spouse ordinarily inhabited it in every year following the deceased's death until the disposition.

Because a trust and its beneficiary are distinct taxpayers, there used to be uncertainty about whether or not a trust, other than a spousal trust, could claim the principal residence exemption when the trustees owned the property and a beneficiary occupied it. Paragraph 54(g) of the Act now specifically permits personal trusts, including a spousal trust, to claim the principal residence exemption. A personal trust, which is defined in subsection 248(1), may be established during a taxpayer's lifetime or by will. A house owned by the trustees qualifies for the exemption if it is ordinarily inhabited by an individual who is beneficially interested in the trust (the "specified beneficiary") or by his or her spouse, former spouse or child. The limit of one principal residence for a family unit applies to the specified beneficiary and his or her family unit. The provision applies to a dispositions after 1990. In the year of disposition, the trust must make the principal residence designation.

Lifetime Capital Gains Exemption

Only three-quarters of the gain (the "taxable capital gain") from a capital source is included in income for tax purposes. The three-quarters portion is taxed in the normal fashion at the taxpayer's marginal rate. The other one-quarter portion is tax free. In effect, income from a capital source is taxed at 75% of the rate normally applied to income from a non-capital source.

The general rule was subject to the capital gains exemption introduced for individuals. For 1988 and subsequent taxation years, the maximum exemption was limited to $100,000 of the gains realized on the disposition of any capital property, other than qualified farm property and shares of small business corporations. For both of these types of property, the limit is $500,000. It must be remembered that these limits represent the total capital gain and not the "taxable capital gain", which is actually three-quarters of the total capital gain.

The introduction of the capital gains exemption created an anomaly with respect to the individual and the categorization of income by source. On the one hand, the gradual movement towards full taxation of capital gains made the source distinction less important, while on the other hand, the introduction of the exemption has made the source distinction more important, in a return to a situation similar to that before 1972 when all capital gains were tax-free.

The February 22, 1994 federal budget eliminated the $100,000 Lifetime Capital Gains Exemption for gains that accrue after budget day, but makes no change to the $500,000 Lifetime Capital Gains Exemption for farm property and qualifying small business shares. Capital gains accruing up to budget day remain eligible for the exemption under the existing pre-1994 budget rules.

As stated, the $500,000 capital gains exemption remains in place for qualified farm property and shares of a qualifying small business corporation. In <u>very general terms</u>, a small business corporation is a Canadian controlled private

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[125] Subs. 40(5).

[126] Para. 54(g)(vi) deems that property designated as a principal residence by a spouse who is a beneficiary under a spouse trust will be the principal residence of both the spouse and the spouse trust.

corporation all or substantially all of the assets of which were used in an active business carried on primarily in Canada. (See s.248(1) ITA for definition of small business corporation).

Crystallization of Capital Gains Exemption

On February 22, 1994 (budget day), John held $60,000 in shares that cost $20,000 and John had $25,000 of capital gains exemption remaining. Since just 75% of a capital gain is taxed, the taxable portion of a $25,000 gain is $18,750. That's the amount on which John can save tax.

Feb. 22 value of John's shares	$60,000
Less: original adjusted cost base	-20,000
Unrealized capital gain	40,000
Crystallization value set by John	$45,000
Less: original adjusted cost base	-20,000
Crystallized gain	25,000
75% taxable portion of capital gain included in net income	$18,750
Less: capital gains deduction @ 75%	-18,750
Net taxable amount	0

If John later sells his shares for $80,000, his cost base for the capital gain will be $45,000 - the crystallization value that represents his original $20,000 plus $25,000 of tax-free gains. So, the taxable capital gain would be $35,000 ($80,000 - 45,000). If John does not crystallize, that gain will be based on his original $20,000 cost, so the taxable capital gain would be $60,000.

If John later sells the shares for $15,000, his capital loss will be based on the $45,000 crystallization value, and the capital loss will be $15,000 - 45,000 = $30,000 capital loss.

21-Year Deemed Disposition of Trust Property

Section 104 of the ITA prevents a trust from holding property for an indefinite period, thereby deferring the taxation of capital gains and recapture. Generally, there is a deemed disposition and reacquisition by the trust of capital property every 21 years for notional proceeds equal to fair market value. Where the property owned by the trust has appreciated in value, consideration should therefore be given to distributing the trust property to the beneficiaries before the 21-year period has elapsed. Generally, this can be accomplished on a tax-free basis if the trust is a personal trust.

With the exception of certain spousal trusts, the first deemed realization occurs 21 years after the creation of the trust, although trusts in existence on January 1, 1972 will have their first realization 21 years after such date. Certain spousal trusts, however, may be deemed to dispose of their property at intervals other than every 21 years. For these trusts, the first deemed disposition occurs on the date of the spouse's death and every 21 years thereafter. These spousal trusts must satisfy the basic requirements of a spousal trust in that the spouse must be entitled to receive all the income of the trust arising during his or her lifetime and no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust. In addition, these trusts must be created in either of the following ways:

1. By the will of a taxpayer who died after December 31, 1971; or
2. By a taxpayer during his lifetime (other than a pre-June 18, 1971, *inter vivos* trust taxed at the graduated rates applicable to individuals).

1991 Changes To The 21-Year Rule

Amendments to the 21 year rule were introduced in 1991.

As 1993 was approaching, bringing with it the deemed disposition of assets for pre-1972 trusts, a significant number of concerns were raised regarding the harshness of the rule. In response to intense lobbying, a special election was adopted in 1991 which allowed a trust to postpone the deemed disposition and capital gains taxation on trust property until the death of the last "exempt beneficiary" of the trust. "Exempt beneficiaries" are persons who stand in certain relationships to the "designated contributor" of the trust (that is, designated by the trust in prescribed form). For testamentary trusts, the "designated contributor" is the person on account of whose death the trust is established. For an *inter vivos* trust, the "designated contributor" is the dominant contributor to the trust (and must have been the dominant contributor from the first anniversary of the establishment of the trust until the date on which deemed disposition would occur, but for the election). In addition, an individual may be a "designated contributor" who controls shares of a corporation, shares of which constitute the primary component of the trust property. "Exempt beneficiaries" include the following relatives of the "designated contributor": Spouse, grandparents, parents, brothers, sisters, children, nieces and nephews.

There were two disadvantages of a trust's electing under the 1991 rules to defer the deemed disposition. First, once an election was made by the trust, property could be rolled out on a tax-free basis from such a trust only to exempt beneficiaries; distribution to any other beneficiary will be made at fair market value. Second, the preferred beneficiary election could not be used to allocate income arising during the "extension period". Consequently, only actual distributions of income reduced the trust's income for tax purposes. The Financial Post & Globe & Mail articles on the following pages provide some flavour of the debate surrounding the 1991 amendments.

In 1994 the issue of trust taxation was referred by the Minister of Finance to the Finance Committee. The Finance Committee concluded that the 21-year deemed disposition rule for trusts was punitive and inconsistent with the rest of the income tax system because neither individuals nor corporations are taxed on accrued but unrealized capital gains every 21 years. The Finance Committee also stated that the election to defer the deemed disposition for trusts had not resulted in significant losses of tax revenues since there are other measures to avoid the deemed disposition which would likely have been used. The Finance Committee recommended that the election to defer the 21-year deemed disposition rule be retained.

being tough on the rich. But it has tougher laws about this sort of thing than Canada does.

Some time in the next few months, the Brian Mulroney government will try to pass its proposed new change quietly into law. It will present the change to the House of Commons in the form of a legislated amendment and hope that the few MPs and members of the public watching will have little awareness of the money at stake.

And then it will return to the pressing matter of reducing the deficit.

Globe and Mail, May 31, 1994
Tax break may have cost $1 billion

Wealthy families lobbied Mulroney government to extend exemption on trusts

OTTAWA - The Mulroney government may have given up as much as $1-billion last year when it extended a 21-year tax exemption to family trusts, documents show.

The Conservatives agreed to extend the tax-free status to family trusts after extensive lobbying by the Canadian Association of Family Enterprise.

The information was obtained under the Access to Information Act.

During that lobbying, the association, which counts some of the wealthiest families in Canada among its members, supplied the Finance Department with a detailed financial survey from its membership.

With 120 member families responding, the survey showed the average tax bill for the trusts would have been $9.9-million had the exemption from capital gains tax not been extended and had no other alternative breaks been applied.

The average was based on a range in potential tax bills between $60,000 and $72-million.

Family trusts were exempted from capital gains tax by prime minister Pierre Trudeau's government in 1972 under a 21 -year rule.

As of Jan. 1, 1993, the assets in the trusts were to be deemed to be cashed out and then taxed on capital gains. But the Tories extended the protection for an extra generation.

Gordon Sharwood, a former banker and founding chairman of the family enterprise group, said last week the group was able to persuade former finance minister Michael Wilson that some members would face hardship without the extension.

Letters between Mr. Sharwood, Mr. Wilson and former deputy minister Fred Gorbet show association members met Finance Department officials several times.

The survey showed 76 per cent of the respondents either had or were planning to move assets out of the trusts because of the possible deemed disposition.

Bloc Quebecois finance critic Yvan Loubier said yesterday the current government should step in and block the tax-free status.

"To cut unemployment insurance and to continue with family trusts is inequitable," Mr. Loubier said.

Finance Minister Paul Martin promised in the Feb. 22 budget to review family trusts.

Terrie O'Leary, Mr. Martin's executive assistant, said the Finance Department is two or three weeks away from completing a discussion paper on family trusts.

1995 Federal Budget - More Changes!

The timing of the release of the Finance Committee's report was unfortunate since the Budget was tabled just four days later and did not appear to take into account the Finance Committee's recommendations on the 21-year rule. Accordingly, the February 1995 Federal Budget eliminates the exempt beneficiary election for years after 1998. For trusts that have made this election prior to 1999, there will be a deemed disposition of trust assets, at fair market value, on January 1, 1999. To avoid this deemed disposition, such trusts can distribute their property to beneficiaries before that date. If property is distributed to a particular exempt beneficiary, capitals gains will not be realized until the property is disposed of or until the death of the survivor of the beneficiary and his or her spouse. However, distribution to beneficiaries is not an attractive alternative if the trustees wish to retain control over the trust property. As well, the terms of some trusts may not permit a distribution of capital property prior to 21 years and it may be necessary to apply to the court for a variation.

CHAPTER 8 - ALLOCATION OF INCOME AND CAPITAL GAINS TO BENEFICIARIES

Reduction in Computing the Income of the Trust

Subject to certain exceptions, where one of the following conditions is met, all or part of the income may be deducted from the income of the estate or trust and included in that of a beneficiary or beneficiaries:

1. Where income is payable to the beneficiary;
2. Where income is deemed payable to an infant;
3. Where a preferred beneficiary elects to pay tax on accumulating income; (The preferred beneficiary election was eliminated in the February 1995 Federal Budget for taxation years after 1995).
4. Where the trustee makes payments in respect of property which the trustee is required to maintain for the use of a beneficiary

Paid or Payable to Beneficiary

An amount will be considered payable to a beneficiary in a year if paid to the beneficiary, or if the beneficiary is entitled to enforce payment. Even if payable to a beneficiary, an amount of income may be taxed to the trust where the trust so designates (subsections 104(13.1) and (13.2)). In that case, the income is deemed not to be payable to the beneficiary. The inclusion of such an amount in the income of the trust instead of a beneficiary is particularly advantageous where the trust has loss carryovers that may be deducted in calculating its taxable income.

Benefit Under Trusts s.105(2) - ITA

(2) Upkeep. etc. Such part of an amount paid by a trust out of income of the trust for the upkeep, maintenance or taxes of or in respect of property that, under the terms of the trust arrangement, is required to be maintained for the use of a tenant for life or a beneficiary as is reasonable in the circumstances shall be included in computing the income of the tenant for life or other beneficiary from the trust for the taxation year for which it was paid.

Designation to Retain Income

- When the income of a trust is paid or payable to the beneficiary, the income is normally taxed in the beneficiary's personal income tax return. A designation under subsection 104(13.1) or (13.2) deems such income not to have been paid by the trust and thus, taxed within the trust.
- Subsection 104(13.1) permits a trust to make a designation in respect of any portion of income paid or payable to beneficiaries.
- Subsection 104(13.2) permits a designation in respect of any portion of the taxable capital gains of the trust that would otherwise be included in a beneficiary's income.
- An estate planner might therefore think in terms of creating a spousal trust of which the spouse was the sole trustee, rather than providing for an outright spousal transfer; so that an additional taxpayer (the trust) could be maintained during the lifetime of the spouse. The same principle could be extended to gifts to children: instead of being the recipient of an outright gift, each child could be the trustee of a trust of which he or she was the principal beneficiary.
- The designations are ineffective unless proportionate designations are made for each beneficiary to whom income or capital gains are payable.
- If all or a portion of the beneficiary's allocation of trust income is taxed at a rate greater than the lower marginal rate of tax, the benefits from the graduated rates of tax afforded to a testamentary trust can be maximized with a subsection 104(13.1) designation.
- Subsection 104(13.1) designations would be made to utilize non-capital losses before they expire.

- Subsection 104(13.2) designations would be made to utilize net capital losses in the trust which can only be deducted against taxable capital gains.
- Testamentary trusts are not required to make tax instalments whereas the beneficiary may be required to make instalments (but the trust must pay balance of tax within 90 days after year end compared to four months or April 30 for individuals).
- These designations cannot be late filed
- Make designations based on individual beneficiary situations

Administrative Practice

While an estate is being administered no beneficiary has any right to demand a payment or distribution of income or capital.[49] It must follow that, strictly, no amount could be included in a beneficiary's income as income payable to him during administration except insofar as amounts were actually paid. In practice, a deduction from the income of the trust and an inclusion in the income of beneficiaries are permitted by the Department of National Revenue, if, in his accounts, the personal representative allocates the income to the beneficiaries and if all the beneficiaries consent.

The discussion of Interpretation Bulletin IT-286R2[50] suggests that this practice is limited to the executor's year and that it will apply only if that year and the trust's taxation year coincide. In *Grayson v. M.N.R.,*[51] the taxpayer was the sole executor and beneficiary under a will. The estate appears to have been fully administered in its first taxation year which coincided with the executor's year. It received interest income in that year and in the succeeding year and the executor reported such income as income of the estate. The Minister included the amounts in the taxpayer's income for each year on the ground that they were payable to him *qua* beneficiary and the assessment was upheld. The decision is inconsistent with the statements with respect to Revenue Canada's current assessing practice in the Interpretation Bulletin as far as the first taxation year of the estate is concerned and even if, as the report suggests, the estate was fully administered before the end of the executor's year, it would appear to be incorrect in law as far as the income of that year was concerned.

The executor's year is simply the first twelve months after the deceased's death and is the period traditionally allowed to an executor to pay debts and generally settle the estate so that it is ready for distribution to the beneficiaries.[52] The rule that executors cannot be compelled to pay legacies or distribute income or capital to beneficiaries in the year is quite firmly established and on that basis it could not be said that the taxpayer in his or her capacity as beneficiary was entitled in the first year to enforce payment of the interest income. The fact that the taxpayer was both the sole executor and beneficiary may well have contributed to the decision although, strictly, that fact should have been irrelevant.

For a variety of reasons, including tax disputes, many estates remain under administration for a period that extends significantly beyond the executor's year. In such cases, beneficiaries could not legally demand payment of undistributed income and even if correct on its facts, the decision in *Grayson v. M.N.R.* should not be applicable.

One of the reasons given by the taxpayer in *Grayson's* case for his failure to wind up the estate was a desire to prevent capital losses from being wasted.[53] If there was evidence that it was reasonably anticipated that offsetting capital gains might have been realized in the near future, this would seem to be a ground on which a court might well conclude that the estate was not fully administered, and that income was not payable to the beneficiary, at least during the first taxation year.

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[49] Re Neeld; *Carpenter v. Inigo Jones*, [1962] 2 All E.R. 335 (C.A.). See also *R. v. Commissioners for Special Purposes of the Income Tax Act*, [1921] 2 A.C. 1 (H.L.), affirming [1920] 1 K.B. 468 (C.A.).
[50] April 8, 1988, "Trusts-Amount Payable"
[51] [1990] 1 C.T.C. 2303, 90 D.T.C. 1108 (T.C.C.)
[52] *Re Perrin* (1925), 28 O.W.N. 173 (H.C.)
[53] Note that subs. 164(6) provides for a carryback of capital losses to the terminal year.

Allocation of Income From Trust

Let us assume an estate has high income beneficiaries. It may be desirable, in the first year after death, to refrain from transferring assets to beneficiaries so that income can be earned and taxed at the estate level. Such income can then, if the fiscal life of the estate straddles two calendar years, be allocated to the estate beneficiaries as income taxable in the later year, even if much of it was paid in the former year, thereby achieving some tax deferral for the beneficiaries.

For example, Jim dies on July 5, 1995. His will leaves the residue of his estate to his 2 sisters, both of whom are in high marginal tax brackets. In the first year of the estate - July 6, 1995 to July 5, 1996, the executors may hold all assets in the estate and the income earned thereon will be taxed in the estate's income tax return, to be filed within 90 days of July 5, 1996.

In the second year of the estate - July 6, 1996 - July 5, 1997, the executor may distribute the assets and allocate the income to Jim's 2 sisters. This income will be deemed received by the 2 sisters in the calendar year 1997, to be included in the sisters' 1997 tax returns. Payment of the tax on this income is not due until April 30, 1998.

Interpretation Bulletin IT-286R2 - Trusts—Amount Payable

April 8, 1988

Subsection 104(24) (also subsections 52(6), 104(4), (5), (5.1), (6), (13) and (18) and 107(4), paragraph 149(1)(o.4) and subparagraphs 110(1)(a)(i) to (vii))

Application

This bulletin cancels and replaces IT-286R dated October 4, 1982. Proposals contained in the Department of Finance press release of October 1, 1987 on trusts and their beneficiaries are not considered in this release.

Summary

Certain trusts, in computing their income for a taxation year, are permitted to deduct any income payable in the year to a beneficiary. This bulletin deals with the meaning of "an amount payable in a taxation year" for purposes of the deduction. It also discusses specific situations where amounts are payable and other situations where they are not.

Discussion and Interpretation

1. Subsection 104(6) of the Act. which permits a trust to deduct certain amounts in computing income, applies to an "employee trust" and a "trust governed by an employee benefit plan" in paragraphs 104(6)(a) and (a.1) respectively while paragraph 104(6)(b) applies to any other trust. This bulletin deals only with income deductions allowed under subsection 104(6) to trusts to which paragraph 104(6)(b) applies. "Employee Trusts" and "trusts governed by employee benefit plans" are dealt with in IT-502. See IT-342 for information concerning amounts to be included in computing the income of a beneficiary of a trust to which paragraph 104(6)(b) applies.

2. Subject to the limitations on spouse trusts as explained in 3 below, a trust to which paragraph 104(6)(b) applies can, by virtue of that paragraph, deduct from its income for a taxation year such part of its income, including its net taxable capital gains, as was payable in the year to a beneficiary. However, the amount so deducted must, by virtue of subsection 104(13), be included in the income of the beneficiary to whom it was payable. The meaning of "an amount payable in a taxation year" is defined in subsection 104(24) as an amount

(a) that is paid in the year to the person to whom it was payable, or
(b) with respect to which the person to whom it was payable is entitled in the year to enforce payment.

3. In computing income for a taxation year a Trust described in paragraph 104(4)(a) (i.e.: a spouse Trust) is, by virtue of paragraph 104(6)(b), prevented from deducting such part of its income as was payable in the year to a beneficiary out of taxable capital gains or other income arising as a consequence of a disposition of property under subsection 104(4) or (5) or 107(4) unless

(a) the trust was created before November 13, 1981, and

Distribution of Capital From Trust s.107(2) - ITA

(2) Capital interest distribution by personal or prescribed trust — Where at any time any property of a personal trust or a prescribed trust has been distributed by the trust to a taxpayer who was a beneficiary under the trust in satisfaction of all or any part of the taxpayer's capital interest in the trust, the following rules apply:

(a) the trust shall be deemed to have disposed of the property for proceeds of disposition equal to its cost amount to the trust immediately before that time;

(b) the taxpayer shall be deemed to have acquired the property at a cost equal to the total of its cost amount to the trust immediately before that time and the amount, if any, by which

Proposed Amendment — 107(2)(b)

(b) the taxpayer is, subject to subsection (2.2), deemed to have acquired the property at a cost equal to the total of its cost amount to the trust immediately before that time and the amount, if any, by which

(i) the adjusted cost base to the taxpayer of the capital interest or part thereof, as the case may be, immediately before that time as determined for the purposes of paragraph (1)(b)

exceeds

(ii) the cost amount to taxpayer of the capital interest or part thereof, as the case may be, immediately before that time;

Distributions of Capital from Trust

The taxation consequences of a distribution of capital by a trust vary as between spouse trusts and other personal trusts. In the usual case, a distribution from a personal or prescribed trust which is not a spouse trust will give rise to no realization of gains or losses. Under subsection 107(2), non-depreciable capital property will simply roll out of the trust at its adjusted cost base. Obviously, if this rule were applied to spouse trusts during the lifetime of the spouse, it would be a comparatively simple matter to avoid the deemed realization which is intended to occur on the death of the spouse. Accordingly, it is provided in subsection 107(4) that if capital property is distributed to a beneficiary of a spouse trust, any gains or losses on the property will be realized unless the recipient beneficiary is the spouse. If the recipient is the spouse, the property will roll out at its adjusted cost base in the usual case.

If the trust is not a spouse trust, the trust is deemed by paragraph 107(2)(a) to have disposed of the property for proceeds equal to its cost amount to the trust. Under paragraph 107(2)(b), the beneficiary will acquire the property at the same amount unless he has an adjusted cost base for his capital interest. For our purposes, the beneficiary will have such an adjusted cost base only if he or she acquired the interest from another beneficiary. If this is the case, the beneficiary will acquire the property at a cost equal to the greater of its adjusted cost base to the trust and the adjusted cost base of his or her capital interest. This rule ensures that a beneficiary who has, for example, purchased his or her capital interest for an amount greater than the cost of the property in the trust will acquire the property at a cost equal to the purchase price he or she provided for the interest. If this were not so, there would be an element of double taxation when he or she subsequently disposed of the property.

Example - Usual case

(a) Distribution of non-depreciable capital property to original capital beneficiary of the trust (non-spousal trust)

a.c.b. of the property to the trust = $1,000
f.m.v. of the property = $5,000

Paragraph 107(2)(a): the trust is deemed to have received proceeds of disposition of $1,000.

Paragraph 107(2)(b): the beneficiary is deemed to have acquired the property at a cost of $1,000

Paragraph 107(2)(c): the beneficiary is deemed to have disposed of his capital interest for $1,000

Result: a realization of the capital gain is deferred until the beneficiary subsequently disposes of the property.

(b) Distribution of non-depreciable capital property to a purchaser of a capital interest (non-spousal trust)

a.c.b. of the property to the trust	$1,000
f.m.v. of the property to the trust	$5,000
amount paid for the purchase of the capital interest	$3,000

Paragraph 107(2)(a): the trust is deemed to have received proceeds of disposition of $1,000

Paragraph 107(2)(b): the purchaser is deemed to have acquired the property at a cost of $1,000 + (3,000 - 1,000) = $3,000. This will be the greater of cost to the trust and cost to the beneficiary.

Paragraph 107(2)(c): the purchaser is deemed to have disposed of his capital interest for $3,000.

Result: No capital gain is realized on the distribution and the adjusted cost base of the property to the purchaser reflects the cost at which he or she acquired the capital interest.

If this was <u>not</u> the case, purchaser's cost would be deemed to be $1,000, and the increase in value from $1,000 to $3,000 would be captured twice — once on the disposition by the original beneficiary to the purchaser, and then again when the purchaser ultimately disposes of it.

Distribution of Principal Residence S.107(2.01) - ITA

(2.01) Distribution of principal residence — Where a property that would, if a personal trust had designated the property under paragraph (c.1) of the definition "principal residence" in section 54, be a principal residence (within the meaning of that definition) of the trust for a taxation year, is at any time (in this subsection referred to as "that time") distributed by the trust to a taxpayer in circumstances to which subsection (2) applies and subsection (4) does not apply and the trust so elects in its return of income under this Part for the taxation year that includes that time,

(a) the trust shall be deemed to have disposed of the property immediately before the particular time that is immediately before that time for proceeds of disposition equal to the fair market value of the property at that time; and

(b) the trust shall be deemed to have reacquired the property at the particular time at a cost equal to that fair market value.

OVERVIEW RE: DISTRIBUTION OF PRINCIPAL RESIDENCE

Effective for distribution occurring after 1990, subsection 107(2.01) generally allows a personal trust to claim the principal residence exemption on a transfer of a principal residence to a beneficiary of the trust in satisfaction of all or part of his or her interest in the trust. Prior to the amendment of subsection 107(2.01) by S.C. 1993, c. 24, s. 43(3), only spousal trusts described in subsection 70(6) or 73(1) could benefit from this provision, provided that the distribution occurred after May 9, 1985 and the trust notified the Minister of National Revenue in writing before April 1992 (if the distribution occurred before December 17, 1991). For distributions of a principal residence from such a spousal trust occurring after December 16, 1991, the election must be made in its return for the year in which the transfer is made.

Where the trust so elects in its return for the year in which the transfer is made, the trust is deemed to have disposed of the property (the principal residence) immediately before the transfer at fair market value and to have reacquired the property at that same fair market value. If the property qualifies as a principal residence of the trust (see paragraph 54(g)), the trust should be able to claim the principal residence exemption on any resulting capital gain.

As a result of subsections 107(2.01) and 107(2), the beneficiary will generally acquire the property (the trust's principal residence) at fair market value, and any subsequent accretion in value can be sheltered upon a subsequent disposition by the beneficiary, assuming the property becomes the principal residence of the beneficiary. Without subsection 107(2.01), the beneficiary acquiring the property may be put in a position where he or she will be paying tax (on a subsequent disposition by the beneficiary) on the gain which accrued while the property was in the trust, for which no principal residence exemption was previously claimed. That is, the property would generally be rolled over to the beneficiary under subsection 107(2) at the historical cost of the property to the trust, and assuming the beneficiary did not ordinarily inhabit the property while it was owned by the trust, the property would not qualify as the beneficiary's principal residence for those years it was owned by the trust. (Subsection 40(7) provides that the beneficiary is deemed to have owned the property continuously since the trust last acquired it, but it does not provide that the beneficiary inhabited the property over that time.)

CHAPTER 9 - "SOME HISTORY" - PREFERRED BENEFICIARY ELECTIONS

Clause Establishing Basic Children's Trust

I DIRECT my Trustees to hold the residue of my estate until such time as there is no longer any child of mine living and under the age of * years. Until such time my Trustees may from time to time pay to or apply on behalf of my children or such one or more of them to the exclusion of the other or others and in such proportions as my Trustees may determine, all or so much of the net income of the residue of my estate and so much of the capital thereof as my Trustees determine to be appropriate for the respective benefit of my children. Any income from the residue of my estate which is not so paid or applied in any year shall be accumulated by my Trustees and added to the capital of the residue of my estate and dealt with as part thereof and provided further that if after the expiration of the maximum period for the accumulation of income permitted by law there are still children of mine living and under the age of * years, my Trustees shall thenceforth pay or apply the whole of the net income of the residue of my estate to or on behalf of my children or such one or more of them to the exclusion of the other or others and in such proportions as my Trustees determine.

Preferred Beneficiary Election

The Preferred Beneficiary Election was an extremely useful tax planning device which was eliminated by the February 27, 1995 Federal Budget, except for restricted cases of mentally or physically impaired beneficiaries.

WHAT WAS THE PREFERRED BENEFICIARY ELECTION?

The preferred beneficiary election allowed trust income to be allocated for tax purposes only to "preferred beneficiaries". Income from a trust could be taxed in the preferred beneficiary's hands rather than the trust without requiring any actual distribution of income to the preferred beneficiary at any time.

In other words, where a trust was given discretion to accumulate income rather than pay it all out to beneficiaries, the preferred beneficiary election was a method by which the income could be taxed in the beneficiary's hands, even though it was accumulating in the trust.

The preferred beneficiary election was commonly used to split income among children whose tax rate was lower than the trust (testamentary or *inter vivos*).

Now in order to take advantage of the lower rate of tax of beneficiaries, the income must actually be paid or payable to them.

The General Rules relating to Preferred Beneficiary Elections may be summarized as follows:

General Rules

- Where a trust that had not paid a portion of its income to its beneficiaries during the year or was not required to pay any such income to its beneficiaries, any taxes on this "accumulating income" would be payable at the trust level using the trust's rate of tax.
- Where it was preferable to have the income taxed in a beneficiary's hands, the trust and a preferred beneficiary made a joint election to have the preferred beneficiary include his or her share of the "accumulating income" of the trust for the year in his or her personal tax return.
- The income was not included in the beneficiary's income when subsequently paid.
- Income required by the preferred beneficiary election to be included in computing the income of the preferred beneficiary may be deducted in computing the income of the trust.
- The election may be made for one or more preferred beneficiaries. (Separate elections must be filed).

Definitions

- Preferred beneficiary - an individual resident in Canada who is a beneficiary under the trust and is

  i) the settlor of the trust,
  ii) the spouse or former spouse of the settlor of the trust, or
  iii) a child, grandchild or great grandchild of the settlor of the trust, or the spouse of any such person.

- Accumulating income - the net income of the trust, before the election, that would be taxable in the trust.

- Subsection 104(15) of the Income Tax Act and Regulation 2800(3) thereunder set out rules concerning the computation of a preferred beneficiary's share of the accumulating income of a trust.

For Taxation Years After 1995

With the elimination of the preferred beneficiary election, trust income will now be taxable to a beneficiary in a particular year only if it is paid or payable to the beneficiary in that year. Otherwise, the income will be taxed in the trust. The result of the Budget proposals is that actual distributions to trust beneficiaries will be encouraged even though there may be a variety of non-tax reasons for retaining the income in the trust.

The elimination of the preferred beneficiary election appears to be an extreme response to a perceived abuse. Provisions could have been enacted to prevent income subject to the preferred beneficiary election from being distributed to other beneficiaries. In addition, in criticizing a trust's ability to make use of the preferred beneficiary election, neither the Finance Committee's report nor the Budget acknowledged that *inter vivos* trusts are also subject to deemed dispositions and taxation at the highest marginal rate.

The Defendant is to be judged as a reasonably competent notary. He owed the same duty as a solicitor. (*Flandro v. Mitha* (1992) 93 D.L.R. (4th) 222 at 232).

It is not in itself fatal but the Defendant had no authority under the Notaries Act to draw a Will which included trust provisions (see s. 15). The weight of that exception as it applies in this case is that the testator's instructions should have triggered the duty to refer her to a solicitor competent to draft a Will including the provision she sought which was to establish a discretionary trust. She probably would not have known the phrase "discretionary trust" but she knew what she wanted.

The Plaintiffs succeed in their claim. Damages are allowed as set out in paragraph [22].

The Plaintiffs have undertaken not to enforce payment during the lifetime of the Defendant and his wife. They propose security by way of a mortgage on the Defendant's property which is, as I understand it, at or near Oliver, B.C.

The judgment may be settled by agreement on any terms found acceptable to the parties.

Sample Clause Authorizing Trustees to Allocate Assets between Family Trust and Spousal Trust

(b) I DIRECT my Trustees to administer the residue of my estate as follows:

(1) My Trustees shall set aside and keep invested a fund composed of the sum of $1.00 together with that portion or all of the remaining assets forming the residue of my estate as my Trustees in their discretion select. My Trustees shall have the power to determine which specific assets will form part of such fund, provided that any such allocation shall be made prior to the date 36 months following the date of my death (hereinafter referred to as the "Vesting Date"). If no such allocation is made by the Vesting Date, such fund shall be composed solely of the $1.00 amount set out above. I specifically exonerate my Trustees from any responsibility with respect to any such allocation which may result in any liability to my estate or to any beneficiary thereof if my Trustees act bona fide in the exercise of this power. It is also my wish and desire, without placing any obligation on my Trustees so to do, that my Trustees engage legal and accounting experts to advise them as to the income tax consequences under the Income Tax Act (Canada), as amended, or any successor thereto (hereinafter referred to as "Income Tax Act") and any other tax consequences of any kind pursuant to any legislation of any jurisdiction, of allocating or not allocating any of the assets of the residue of my estate to such fund. In particular, as well as considering the provisions of both the Spousal Trust and Family Trust (as hereinafter defined) I should like my Trustees to consider the relative advantages of deferring income tax liabilities arising at my death in respect of my assets, by allowing a portion or all of the residue of my estate to be administered as part of the Spousal Trust and thereby taking advantage of the provisions of subsection 70(6) of the Income Tax Act as compared with permitting income tax liabilities to arise at my death pursuant to subsection 70(5) of the Income Tax Act, by allocating a portion or all of the residue of my estate to such fund. The fund finally set aside by my Trustees shall hereinafter be referred to as the "Family Trust" and shall be dealt with as hereinafter provided:

(A) During the lifetime of my spouse, my Trustees shall keep the Family Trust invested and shall pay to or on behalf of my spouse and my issue or such one or more of them to the exclusion of the other or others and in such proportions as my Trustees see fit, the whole or such portion of the net income derived from the Family Trust as my Trustees may from time to time determine. Any income which is not so paid or applied in any year shall be accumulated and added to the capital of the Family Trust and dealt with as part thereof. After the expiration of the maximum period permitted by law for the accumulation of income, my Trustees shall pay to or apply on behalf of my spouse and my issue or such one or more of them to the exclusion of the other or others and in such proportions as my Trustees see fit the whole of the net income from the Family Trust.

(B) In addition my Trustees may at any time and from time to time pay to or on behalf of my spouse and issue or such one or more of them to the exclusion of the other or others such part or parts of the capital of the Family Trust as my Trustees may determine to be necessary or desirable for the respective benefit of my spouse and issue.

(C) In administering the discretions given to them in the foregoing clauses (A) and (B) my Trustees shall be mindful that my spouse is to be the primary beneficiary of the Family Trust.

CHAPTER 11 - POST MORTEM PLANNING

Disclaimers, Releases or Surrenders by Beneficiaries - s. 248(8) - ITA

(8) Occurrences as a consequence of death — For the purpose of this Act,

(a) a transfer, distribution or acquisition of property under or as a consequence of the terms of the will or other testamentary instrument of a taxpayer or the taxpayer's spouse or as a consequence of the law governing the intestacy of a taxpayer or the taxpayer's spouse shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer or the taxpayer's spouse, as the case may be;

(b) a transfer, distribution or acquisition of property as a consequence of a disclaimer, release or surrender by a person who was a beneficiary under the will or other testamentary instrument or on the intestacy of a taxpayer or the taxpayer's spouse shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer or the taxpayer's spouse, as the case may be; and

(c) a release or surrender by a beneficiary under the will or other testamentary instrument or on the intestacy of a taxpayer with respect to any property that was property of the taxpayer immediately before the taxpayer's death shall be considered not to be a disposition of the property by the beneficiary.

(9) Definitions — In subsection (8),

"disclaimer" — "disclaimer" includes a renunciation of a succession made under the laws of the Province of Quebec that is not made in favour of any person, but does not include any disclaimer made after the period ending 36 months after the death of the taxpayer unless written application therefor has been made to the Minister by the taxpayer's legal representative within that period and the disclaimer is made within such longer period as the Minister considers reasonable in the circumstances;

"release or surrender" — "release or surrender" means

(a) a release or surrender made under the laws of a province (other than the Province of Quebec) that does not direct in any manner who is entitled to benefit therefrom, or

(b) a gift inter vivos made under the laws of the Province of Quebec of an interest in, or right to property of, a succession that is made to the person or persons who would have benefited if the donor had made a renunciation of the succession that was not made in favour of any person,

and that is made within the period ending 36 months after the death of the taxpayer or, where written application therefor has been made to the Minister by the taxpayer's legal representative within that period, within such longer period as the Minister considers reasonable in the circumstances.

CHAPTER 13 - INTER VIVOS PLANNING - INCOME SPLITTING

Inter Vivos Transfer of Property to Spouse or Spouse Trust - s.73(1) ITA

Section 73.

(1) For the purposes of this Part, where at any time after 1977 any particular capital property of a taxpayer has been transferred to

- (a) the taxpayer's spouse,
- (b) a former spouse of the taxpayer in settlement of rights arising out of their marriage, or
- (c) a trust created by the taxpayer under which
    - (i) the taxpayer's spouse is entitled to receive all of the income of the trust that arises before the spouse's death, and
    - (ii) no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust,
- (d) [Repealed]

and both the taxpayer and the transferee were resident in Canada at that time, unless the taxpayer elects in the taxpayer's return of income under this Part for the taxation year in which the property was transferred not to have the provisions of this subsection apply, the particular property shall be deemed to have been disposed of at that time by the taxpayer for proceeds equal to,

- (e) where the particular property is depreciable property of a prescribed class, that proportion of the undepreciated capital cost to the taxpayer immediately before that time of all property of that class that the fair market value immediately before that time of the particular property is of the fair market value immediately before that time of all of that property of that class, and
- (f) in any other case, the adjusted cost base to the taxpayer of the particular property immediately before that time,

and to have been acquired at that time by the transferee for an amount equal to those proceeds.

Section 73 provides an exception to the general rule set out in section 40 that a taxpayer who disposes of capital property must take into account all accrued gains and losses thereon at the time of disposition. In effect section 73 allows a taxpayer to accomplish an *inter vivos* tax-free rollover with respect to capital property where the taxpayer transfers it to an individual or trust specified in paragraphs 73(1)(a) through (c). Unless the transferor elects that the rollover not apply, realization of accrued gains and losses is postponed until the specified individual or trust disposes of the property. However, because of the attribution rules in sections 74.1 to 74.5, the net gains and losses may be attributed to the transferor if the transferee is the transferor's spouse or a trust for the benefit of the transferor's spouse. (discussed following)

The following conditions must be satisfied for the rollover to apply:

(3) Both the transferor and the transferee must be resident in Canada at the time of the transfer.

(4) The transferee must be:

- (a) The transferor's spouse. Subsection 252(3) defines spouse to include a party to a void or voidable marriage.

(b) The transferor's former spouse and the transfer of the property is in settlement of rights arising out of the marriage. Subsection 252(3) defines former spouse to include a party to a void or voidable marriage.

(c) A trust which is usually called a "spouse trust". Such a trust is one under the terms of which the spouse is entitled to receive the whole of the income arising therein during the spouse's lifetime and no person other than the spouse may during the spouse's lifetime receive or have the use of any income or capital of the trust. The term "income" for these purposes is defined in subsection 108(3). It should also be noted that under subsection 108(4), a trust is not disqualified from being a spouse trust by reason only of a charge made on the trust in respect of certain estate duties or income taxes. Subsection 252(3) defines spouse to include a party to a void or voidable marriage. The spouse trust is also mentioned in subsection 70(6) • • • •

If the above mentioned circumstances exist, section 73 applies automatically unless an election is made that the section not apply. The fact of the transfer must, however, be reported to the Department in the tax return of the transferor for the year of transfer.

The transferor may elect in his income tax return for the year in which the property is transferred that the provisions of subsection 73(1) not apply. Presumably the election is made by reporting the disposition on the basis that the rollover under subsection 73(1) was not applicable. When such an election is made, the proceeds of disposition will be the fair market value of the property transferred when the property is transferred to a non-arm's length party. If the transferor and transferee are not married to each other it will be a question of fact whether they deal at arm's length. If the transferor and transferee do deal at arm's length it may, in some circumstances, be difficult to determine the proceeds of disposition of the property transferred when an election is made to exclude the application of subsection 73(1).

Income Splitting and Non Arm's Length Dispositions

Apart from statutorily sanctioned "breaks", much of estate planning can be characterized as an ongoing battle of wits between estate planners and those drafting tax legislation to engage in, or prevent, two techniques: income splitting and dispositions at less than fair market value.

Income splitting refers to the technique of shifting property from a high income taxpayer to a lower income taxpayer, and attempting to have the lower income taxpayer rather than the high income taxpayer report the income for tax purposes. Income splitting is expressly rendered nugatory in certain circumstances. First, where one spouse transfers or loans any property to the other on any basis other than a sale at fair market value, income and capital gains from the property are deemed to be income and capital gains to the transferor. Second, where one person transfers or loans any property to a minor person with whom he or she does not deal at arm's length, or a nephew or niece; any income (but not, interestingly, any capital gains) is deemed to be income of the transferor until the minor attains the age of majority.

One can therefore freely split income with one's adult children, but before doing so one has to take careful account of the property that is transferred. If it is cash, no problem will arise; but if it is capital property, a "deemed disposition at fair market value" (dealt with just below), which could have adverse tax consequences, will result.

Not surprisingly, there are rules to prevent indirect income splitting. A transfer or loan to a trust resulting in the payment of income to a trust beneficiary is treated as essentially equivalent to a transfer to the beneficiary.[144] A transfer or loan to a corporation (other than a "small business corporation", which is a private corporation that uses substantially all its assets to earn active business income primarily in Canada), one of the main purposes of which is to reduce the transferor's income and to benefit a spouse, non arm's length minor or nephew or niece owning at least 10% of the shares of the corporation results in deemed attribution at a prescribed rate.[145]

In addition, where an individual transfers property to a trust and retains the capacity to benefit from the trust, all of the income and capital gains of the trust are attributed back to him or her.[146]

Where there is a loan from one individual to any other non arm's length individual and one of the main reasons for making the loan is the reduction or avoidance of tax, income from the loaned property is attributed back to the lender.[147]

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[144] Section 74.1(3).
[145] Section 74.4.
[146] Section 75(2).

Therefore, a parent who lends money to an adult child to pay off a mortgage will not be subject to attribution (because the loan produces no income); but a parent who lends money to a child who invests it could be subject to attribution. In addition, if such a loan bears a below-market interest rate, a market interest rate will be deemed to exist.

Attribution does not apply in respect of transfers at fair market value, or to loans at commercial interest rates, or in respect of business income.

There are also a series of rules that deem dispositions at amounts that the parties would not normally choose to apply. If a transferor either gives property, or sells it at less than fair market value, to a person with whom he or she does not deal at arm's length, he or she is deemed to have disposed of it at fair market value.[148] The recipient who acquires the property as a gift is deemed to receive it at fair market value; while the recipient who pays below-market consideration for the property is deemed to have acquired the property at that value.[149] Between spouses, a presumptive rollover rule applies, but they can elect that the transfer take place at fair market value.[150]

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[147] Section 56(4.1.).

[148] Section 69.

[149] This therefore puts him or her in a worse position than if he or she had received it by gift; because he or she is stuck with a below-market cost base.

[150] They might wish to do so if the transferor wished to trigger a capital gain that would be exempt under the lifetime capital gains.

Transfers or Loans to a Corporation - S.74.4 ITA

The new rules provide that transfers and loans of property made after November 21, 1985 to certain corporations may, in certain circumstances, attract attribution. The following is a brief and overly simplistic, description of the fundamentals of the rules.

1. Section 74.4 does not apply to transfers to small business corporations. Small business corporations are Canadian-controlled private corporations that use all or substantially all of their assets in an active business. This is consistent with a policy that attributes only income from property and not income from business.

2. The section only applies when one of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of an individual and to benefit a "designated person" (defined in subsection 74.5(5)) who is either a spouse or under the age of 18, and either does not deal with the individual at arm's length or is a niece or nephew. Moreover, the person to be benefited must be a "specified shareholder". A specified shareholder is defined in subsection 248(1) as basically a shareholder who owns 10% or more of the shares of the corporation. Where the shareholder is a trust, each beneficiary is deemed to own a portion of the shares equal to his or her proportionate interest in the trust.

3. The amount to be attributed equals the amount of interest or other form of return annually foregone by the transferor/lender by virtue of the transfer having been effected at a consideration less than the fair market value of the property or at a lower than reasonable or prescribed rate of interest. The amount attributed to the individual is included as interest income.

An example of the type of income-splitting that section 74.4 was designed to prevent is as follows: Ms. X transfers income-producing property, such as portfolio investments, to a corporation and takes back fixed value preferred shares. A trust for the benefit of her spouse and children then subscribes for common shares. Any income generated by the corporation on the transferred property is paid to the trust as dividends and then distributed or otherwise allocated to the spouse and minor children in order to take advantage of their lower tax rates.

The effect of triggering section 74.4 can be quite harsh. Unlike the other attribution rules, section 74.4 does not attribute the actual income received by the designated person to the transferor. Rather, where the rule applies, it deems the transferor to receive interest income from the corporation. The amount of the interest is calculated by multiplying the prescribed rate of interest in effect at the time of the transfer by the value of the loaned or transferred property less any consideration received (other than debt or shares of the corporation) by transferor from the corporation. The imputed interest is also reduced by any actual interest or dividends received by the transferor from the corporation in the year. However, the recipient of the dividend income from the corporation must also include the amount received in his or her taxable income. Accordingly, there exists the possibility for double taxation.

As stated above for attribution under section 74.4 to apply, one of the main purposes of the transfer or loan must be reasonably considered to be to reduce the income of the transferor/lender and to benefit a designated person. The determination of the purpose is made on an objective basis at the time the loan or transfer is made. Attribution under section 74.4 will cease to apply upon the occurrence of any of the following events:

(i) the individual who loaned or transferred the property ceases to be a Canadian resident:;

(ii) the designated person ceases to be a designated person or ceases to be a specified shareholder in the corporation;

(iii) the corporation becomes a small business corporation; or

(iv) there is no "outstanding amount" of loaned or transferred property as defined in subsection 74.4(3), i.e. the transferor has been repaid.

A potential pitfall in respect of the application of subsection 74.4 exists where a transfer of property is made to a corporation which at the time of the transfer qualified as a small business corporation but subsequently went offside.

Attribution will apply in any year throughout which the corporation is not a small business corporation. Accordingly, it is essential that there be ongoing monitoring of the corporation's underlying assets to ensure that it maintains its status as a small business corporation.

A key exemption to the section 74.4 attribution rule is the provision that states that a transfer or loan to corporation will not be considered to have been made to benefit a designated person if the following conditions are met:

(i) the only interest that the designated person has in the corporation is a beneficial interest in shares of the corporation held by a trust;

(ii) by the terms of the trust, the designated person may not receive or otherwise obtain the use of the income or capital of the trust while being a designated person; and

(iii) the designated person has not received or otherwise obtained the use of any of the income or capital of the trust and no deduction has been made by the trust in computing its income under either of subsection 104(6) or subsection 104(12) in respect of amounts paid or payable to the designated person or allocated to the designated person by way of a preferred beneficiary election (only for 1995).

Accordingly, when considering trusts which will hold shares of a corporation *(especially in estate freeze situations - discussed in chapter 14)*, one must bear this exemption in mind. As long as the terms of the trust provide that minor children are not entitled to any of the income or capital of the trust until they reach age 18, then there will not be attribution under section 74.4. The exemption also provides flexibility where an individual has children of different ages, some over 18 and some under. It should be noted, however, if the transferor's spouse is a trust beneficiary, then the subsection 74.4(2) exemption will not be available unless the trust provides that the spouse is only entitled to the income or capital of the trust if he or she survives the transferor.

CHAPTER 14 – PROBATE PLANNING

Probate Trusts

One of the most significant job creation schemes implemented by the late provincial NDP government was the increase of probate fees. As a result of the increase in this indirect tax (the decision in *Re Eurig Estate* notwithstanding) a cottage industry of probate planning was born. Lawyers, accountants and financial planners mobilized in large numbers, each peddling the newest probate planning vehicle.

Probate planning, of course, has been a weapon in the estate planner's arsenal for many years. Even prior to the increase in probate fees it was often advisable for an individual to take steps to minimize the fees payable on the application for letters probate by his or her executors. The recent increase in probate fees to, essentially, 1.5% of the value of one's estate merely lowered the threshold at which probate planning was reasonable and cost effective.

<u>When Should Planning be Undertaken?</u>

The first matter that should be considered in any probate fee reduction strategy is the age and station in life of the client. Where the client is relatively young and probate fees may not be payable for thirty or forty years, incurring initial legal fees and long term administrative costs of a probate plan may not be cost-effective. Even a rudimentary analysis which takes into account the opportunity cost of amounts spent today and the present value of probate fees possibly saved in the future may dictate that sophisticated probate planning involving trusts or corporations may be premature. Where a client is older, particularly if the client has no spouse to whom capital assets could be rolled over on death, probate planning through the use of inter vivos trusts may be advisable.

<u>Basic Inter Vivos Probate Trust</u>

The use of an inter vivos trust may have utility as part of a larger estate and probate plan. While the simplest way of reducing probate fees is to give away one's assets before death, few individuals would consider that option palatable. In the proper circumstances a trust provides a means by which the size of one's estate may be minimized before death, without losing the benefit, use or control of the assets transferred to the trust. Assets held in a properly drafted trust do not form part of one's estate upon death, thereby reducing probate fees payable.

In the simplest transaction, the client would transfer non-capital assets (i.e., assets whose capital value does not increase) to an inter vivos trust. The transfer of such assets to a trust would not trigger any capital gains. -The client and some other trusted persons would be the trustees. The terms of the trust should provide for an orderly transmission of trusteeship upon the client's death. For example, it would be appropriate that the client and those persons who are his or her executors could be the original trustees. In this way upon the client's death, trust assets could be dealt with by the executors/trustees as part of an integrated estate plan.

The client may be tempted to be the sole trustee and thereby maintain full control over his assets. This should be resisted. If the trust is to have the intended probate reducing effect, it is important that the trust be real. In other words, trustees with real fiduciary responsibilities should be chosen, otherwise the trust may ,be considered a bare trust. The assets in a bare trust may not avoid inclusion in the client's estate at death.

The client would be the sole income and capital beneficiary of the trust during his or her lifetime, with the remainder to be distributed to the client's beneficiaries on his or her death or at some time thereafter. As the assets-would be trust assets dealt with by the terms of the trust upon the client's death, those assets would not form part of the estate to which probate fees are applicable. The distribution terms of the trust could mirror the terms of the client's will.

It has been suggested that in order to be certain that one has validly created a probate trust, the trust may have to be executed in testamentary form. The argument has been described in the following manner:

> So long as there remains a threshold question as to whether a trust has been created at all, there remains a risk that the disposition will be characterized as testamentary, and that it will fail as a testamentary gift unless it is executed in testamentary form. Therefore, execution of inter vivos trust documents in testamentary form appears to be called for.

The author goes on to point out that if the person's directs that the assets of the estate are to be poured into the trust and dealt with in accordance with its terms (i.e., incorporation by reference), prudence dictates that any amendments to the trust also be made in testamentary form.

Taxation Issues

It is important to note that the utility of such a probate inter vivos trust is for practical purposes often limited to receiving assets of a non-capital nature. Non-capital assets or assets with minimal accrued capital gains are the easiest to deal with as there will be little or no capital gain realized by the transfer into a trust. Only by transferring non-capital assets to an inter vivos trust can one ensure that capital gains taxes are not prematurely triggered.

Assets such as guaranteed investment certificates or bonds may easily be transferred into a trust without causing the pre-payment of capital gains taxes that would in other circumstances be payable only upon death. Indeed, where assets with accrued gains would otherwise have been left on death to a spouse (and thereby enjoyed a rollover), transferring assets into an inter vivos trust will significantly accelerate the payment of taxes. Once one factors in the opportunity cost of the taxes thereby prepaid, the probate savings may be completely overwhelmed.

In the United-States people sometimes use revocable inter vivos trusts to hold assets and reduce U.S. estate taxes. For Canadian purposes, even if the trust was drafted as a revocable inter vivos trust, the realization of capital gains upon a transfer to the trust will likely not be avoided. A pronouncement by Revenue Canada in 1996 effectively eliminated any argument that a transfer to a revocable inter vivos trust does not trigger a disposition of the client's entire interest in the assets transferred.

In addition to triggering capital gains, attribution of income will result if the spouse of the transferor is a beneficiary and trust income is paid to the spouse. Other of the other attribution issues described may also apply. It is likely, however, that the attribution consequences will be irrelevant because the intent of such a trust is not to avoid tax. During the client's life, he or she would have been taxed on all of the income generated by the assets in any event.

Notwithstanding the above concerns, too often the existence of substantial capital assets which would create a taxable gain if transferred to a trust blinds the estate planner to the possibilities that exist for the non-capital assets. Where other probate planning devices such as registering assets in joint tenancy or the use of multiple jurisdiction wills are not appropriate, sheltering some assets by moving them to a probate trust can achieve some degree of probate savings. Unless one does an actual analysis of the costs of the plan versus the potential savings, an estate planner should not be too quick to dismiss a more limited probate plan involving carefully selected assets and an inter vivos trust.

Inter Vivos Spousal Probate Trusts

If the client is elderly and with significant capital assets having significant accrued gains which he or she wishes to protect from the probate net, an inter vivos spousal trust may be a useful option. The client can establish and transfer capital assets to an inter vivos spousal trust which meets the criteria of section 73 of the Act. The terms of the trust should provide that the spouse of the client is entitled to receive all of the income of the trust that arises before the spouse's death and no person-except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust. The client could transfer to such a trust those capital assets which the client no longer requires to meet his or her needs.

If the terms of section 73 of the Act are met, there is a rollover upon the transfer to the trust and no capital gains taxes are triggered at that time. Section 74.1 of the Act will attribute back to the client the income or loss of the spouse from the property transferred. As all income of the trust assets must be paid to the spouse, the income attribution will be total. If the client had retained the assets in his or her own name, however, the total tax paid would have been identical. The result, therefore is relatively tax neutral to the client.

The trust thereby provides several advantages to the client. The trust can hold assets which are superfluous to the client's needs. Assuming that those assets would have been left to the surviving spouse upon the client's death in any event, the client's overall estate plan is maintained. Indeed, if the client is greatly advanced in years a calculated decision may be made to transfer most of his or her assets to the spousal trust, retaining only that portion necessary to meet the client's present

needs. Assets in the spousal trust will not form part of the client's estate for probate purposes, thereby possibly significantly reducing probate fees.

One potential danger of the spousal trust option must be noted. Pursuant to paragraph 1 04(4)(a) of the Act, there is a- deemed disposition of trust property upon the death of the spouse who is the beneficiary of the trust. As a result, if the spouse for whom the trust is established unexpectedly dies before the client, the payment of capital gains taxes will have been accelerated. Had the assets not been transferred to the spousal trust, but instead left to the surviving spouse in the client's will, there would have been no deemed disposition until the death of the last of the two spouses.

Tax Costs

An important long-term adverse tax consequence that should be kept in mind is the fact that inter vivos trusts are taxed at the highest marginal rate on all accumulating income. In either the simple trust or the spousal trust described above, after the client's death the income accumulating in the trust will be subject to the highest rate of tax.

If, however, the assets had not been transferred into an inter vivos trust but remained part of the client's estate, those assets could have been left in a testamentary trust pursuant to the client's will. Full probate fees would have thereby been payable on those assets. However, to the extent that the testamentary trust would have accumulating income (or where a section 104(13.1) election could be made), the testamentary trust would have enjoyed taxation at progressive rates. Thus, by using an inter vivos trust to reduce probate fees the client has abandoned the significant income splitting opportunities available with testamentary trusts.

As a result, the long term income tax consequences must always be carefully weighed against the probate fee savings before determining if a course of action is justified. Where it was not part of the client's estate plan to leave assets in testamentary trusts, or where the client has no spouse, the use of inter vivos trusts may be warranted. One should not, however, rush into a probate plan that appears superficially beneficial without analyzing all of the costs. This is particularly so when one is considering the use of an inter vivos spousal trust, with the resulting transfer of beneficial entitlement to assets to a spouse.

Granovsky v. Ontario [1998] O.J. No. 508

Ontario Court of Justice (General Division), February 12, 1998.

GREER J.:-- Philip Granovsky ("the deceased") died on or about the 24th day of December, 1995, having left two Wills, both of which are dated December 1, 1993, and which the deceased refers to as his "Primary Will" and his "Secondary Will". A limited Grant of the Primary Will was issued by the Court on October 23, 1996, on the condition that the Applicants for Estate Trustee bring on this Application before the Court to determine the status of the two Wills. Probate fees were paid on the assets governed by the Primary Will and the Secondary Will was not submitted to probate nor were probate fees paid on the assets governed by that Will. The issue before me is whether the Secondary Will must also be submitted to probate and whether probate fees must be paid on the assets governed by it.

1. The Two Wills

Under the terms of his Primary Will, the deceased directed the following in paragraph 3.(a):

> The term "my Primary Estate" for all purposes of this my Will shall mean the whole of my property of every nature and kind whatsoever and wheresoever situate, including any property over which I may have a general power of appointment, but excluding those of my shares in the capital of ATINCO PAPER PRODUCTS LIMITED and MILTRO INVESTMENTS LIMITED, any amounts receivable to me from either or both of the aforementioned corporations or ATLANTIC PACKAGING PRODUCTS LTD. and 307189 ONTARIO LIMITED and any assets held in trust for me by any of them.

The Will is 18 pages in length, complex in nature, and has the earmarkings of a well-crafted and well-drafted document in which the deceased has carefully planned the administration of his estate. From the residue of the Primary Estate, the deceased directs the payment of certain charitable bequests, cash legacies, and then directs that the balance of the residue of his Primary Estate be paid to his wife, Shirley Granovsky, if she survives him for 30 days.

CHAPTER 15 - ESTATE FREEZING

What is an Estate Freeze?

In essence, an estate freeze is the process whereby the existing value of assets, such as shares, are determined and crystallized, usually through the vehicle of preference shares. Future growth on those assets is consequently transferred to another vehicle, such as a class of common shares. Those common shares are often owned by a trust for the benefit of the family of the client. One of the main benefits of the estate freeze is that it allows for the future gains to be allocated to others. This has both tax and non-tax benefits. Whether a trust is employed, however, is dependent on the goals of the client.

Benefits of an Estate Freeze

Subsection 70(5) of the Act deems individuals to dispose of capital property immediately before death. The result is the crystallization of all gains accrued to the date of death and, most importantly, the collection of the resulting capital gains taxes by Revenue Canada. An estate freeze which is carried out on a timely basis will delay the deemed disposition of some of those assets at death and thereby defer the payment of the capital gains taxes until a future date. Often the goal of the freeze is to defer the payment of capital gains taxes until the actual disposition of the assets or death of the client's children.

Another income tax benefit of an estate freeze is the ability to divide capital gains (and therefore exemptions and marginal rates) among many taxpayers. When a person dies or disposes of assets he or she will be able to avail himself or herself of capital gains exemptions, if any, and pay tax on the balance of the gains at his or her marginal rate. If the same assets had been the subject of a freeze, only those assets which remained in the name of the individual would be subject to capital gains taxes. Those persons who acquired the growth on the assets subject to the freeze may also enjoy capital gains exemptions and marginal rates of taxation. If, for example, the underlying company qualified as a small business corporation, each of the beneficiaries may be able to shelter $500,000.00 of capital gains on the ultimate disposition of the shares owned by the trust.

Similar principles apply for the income of a trust owning common shares as a result of an estate freeze. If the freeze is properly implemented dividends can be declared on common shares which are owned by the trust, and not on the preference shares owned by the client after the freeze. Those dividends can be divided among many persons by distributions to the beneficiaries (usually the children of the client). This would be income that otherwise would have been taxed at the client's high marginal rate.

Estate planning is made more certain though an estate freeze. Since the client in a freeze will at the time of the freeze .determine with certainty and finality the value of his or her business assets at the time of his or her death, the amount of taxes that will be payable on death can be calculated in advance. This allows for the purchase of life insurance to fund the payment of capital gains taxes on death. Probate fees can also similarly be determined. In this manner, one's estate planning objectives can be achieved at death without concern for liquidity or tax issues. If the intention of the individual is to ensure the orderly transfer of the family business to the succeeding generation intact, an estate freeze will assist in achieving this goal.

Another non-tax objective that is achieved by the freeze is to partially protect the client's assets from claims of future creditors. Of course the client should not and could not carry out any creditor protection scheme if the client would in any way be violating any common law or statutory provisions respecting transfers of property to defeat creditors. Assuming such is not the case, to the extent that future growth in a family company accrues to a family trust and not directly to the client, the client can ensure that those assets owned by the family trust are protected from claims by his or her own future creditors.

Finally, an estate freeze may allow the client to maintain a great degree of control over all of the assets which are the subject of the freeze. Preference shares taken back by the client remain in his or her control. Common shares which are entitled to future growth are held by trustees of a family trust. The trustees of the trust will usually have the power to select among beneficiaries and determine dates of distribution of income or capital. To the extent that the client is one of the trustees, or the trustees are sensitive to the client's desires, an estate freeze will allow the client to maintain some control over assets which he or she has essentially gifted to others. Had such a "gift" been made directly, all control would be lost.

How an Estate Freeze is Accomplished

There are two main methods of creating the subdivision of assets required for an estate freeze. The first is through a rollover utilizing section 86 of the Act and the second is through a section 85 rollover. In addition the type of trust which one would employ depends on whether the assets transferred on the freeze constitute shares of a small business corporation.

Section 86- Reorganization

Exchange of shares by a Shareholder in Course of Reorganization of Capital s.86 (1) I.T.A.

(1) Where, at a particular time after May 6, 1974, in the course of a reorganization of the capital of a corporation, a taxpayer has disposed of capital property that was all the shares of any particular class of the capital stock of the corporation that were owned by the taxpayer at the particular time (in this section referred to as the "old shares"), and property is receivable from the corporation therefor that includes other shares of the capital stock of the corporation (in this section referred to as the "new shares"), the following rules apply:

(a) the cost to the taxpayer of any property (other than new shares) receivable by the taxpayer for the old shares shall be deemed to be its fair market value at the time of the disposition;

(b) the cost to the taxpayer of any new shares of any class of the capital stock of the corporation receivable by the taxpayer for the old shares shall be deemed to be that proportion of the amount, if any, by which the total of the adjusted cost bases to the taxpayer, immediately before the disposition, of the old shares exceeds the fair market value at that time of the consideration receivable for the old shares (other than new shares) that

(i) the fair market value, immediately after the disposition, of those new shares of that class,

is of

(ii) the fair market value, immediately after the disposition, of all new shares of the capital stock of the corporation receivable by the taxpayer for the old shares; and

(c) the taxpayer shall be deemed to have disposed of the old shares for proceeds of disposition equal to the cost to the taxpayer of all new shares and other property receivable by the taxpayer for the old shares.

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Section 86 Estate Freeze

Where a Section 86 reorganization is effected, X will exchange all shares currently held by X in the operating corporation for fixed value retractable preferred shares, with a value fixed at the fair market value of the common shares of the operating corporation at the date the freeze is effected. The exchange of shares is generally carried out pursuant to articles of amendment filed by the operating corporation. It is generally useful to create various new types of shares at the time when the articles of amendment are filed to provide flexibility in assigning share classes to various shareholder interests as part of the reorganization. Once X has exchanged existing shares for new fixed value shares, X may either carry out a complete estate freeze, or a partial estate freeze. That is, X will decide to forego any interest in the future growth of the operating corporation, or X will decide to share in some way in the future growth of the operating corporation. One useful means of carrying out a partial freeze without giving up any voting control over the corporation, is to create various voting and non-voting classes of common shares. The various classes of common shares would share *pari passu* in the growth of the corporation, and would all be entitled to receive discretionary dividends from the corporation. But only one class of shares, the class taken back by X, would be entitled to vote. Since the class of common shares held by X vote, while the other classes of common shares would not vote, X could be satisfied that the existing control over the direction of the corporation would not be diminished by the reorganization. In describing the share classes in the articles of amendment, it is also generally useful to provide that where a discretionary dividend is available, the directors have the right to exclude particular classes of shares from receiving dividends, and to pay discretionary dividends to other classes of shares of a corporation. This provision in the articles of amendment will reinforce the ability of the directors of the corporation to declare dividends payable in any year to the class of common shares that may be held by the trust, while not paying any dividends to the class

of common shares held by X. Revenue Canada, despite the *McClurg* and *Neuman* decisions, has never quite accepted the premise that directors have the authority to allocate dividends among different share classes, particularly where the directors and shareholders of a corporation are in a non-arm's length relationship. The more evident the power of directors in corporate articles to allocate dividends, the less likely it is that Revenue Canada will challenge the allocation.

As suggested in the previous paragraph, where a partial estate freeze is carried out, X will be issued a particular number of voting common shares, while the trust will be issued a particular number of non-voting common shares, after the preferred shares are issued to X. Since at the time of the estate freeze all of the value of the corporation has been locked into the preferred shares issued to X, the common shares can be issued for a nominal value, as the residual value of the corporation at that time is zero. The trust will borrow the necessary funds, be they Ten Dollars ($10.00) or Fifty Dollars ($50.00), from an arms-length financial institution, to enable the trust to purchase the common shares of the operating corporation. In order to establish the legitimacy of the loan transaction, it is important that the loan bear interest at normal commercial rates, and that interest be paid by the trust on the loan to the arms-length financial institution for the period that the loan remains outstanding. In order to eliminate this loan as soon as possible, it is generally recommended that the operating corporation declare a small dividend, payable on the trust's common shares, as soon as possible after the issuance of these shares to the trust. The trust will then repay the financial institution the amount outstanding on the loan, and any interest that has accrued on the loan to the date of repayment. It has become common practice that the trust borrow more than the amount necessary to buy the shares of the operating corporation at the date of purchase, in order to fund any accruing interest liability until the date of repayment of the loan.

At this point, a valid trust has been created, an arms-length loan received from a financial institution, the use of the borrowed funds to acquire shares of the operating corporation, and the acquisition of non-voting common shares by the trust. In this early stage of the tax planning exercise, two goals have already been accomplished. X has been able to freeze the value of the growth shares formerly held by X in the operating corporation at their value at the point in time when the estate freeze takes place. Thus the determination of the capital gains accruing to the estate of X with respect to the originally owned shares of the operating corporation to that point in time can be determined. This will enable X to carry out other estate planning activities with more certainty. X will be able to quantify to a fairly certain degree the tax liability that will arise with respect to the frozen shares. X may then acquire life insurance in order to fund this tax liability.

In addition, since the assessment of probate fees in the Province of Ontario is a function of the value of the estate of the deceased, X will be able to determine the amount of probate fees applicable to the growth shares formerly held by X in the operating corporation to the date of the estate freeze.

Since X has chosen in this example to carry out only a partial estate freeze, X will only be able to make a clear determination of the capital gains and probate fee responsibilities arising with respect to the preferred shares taken back at the time of the estate freeze. As X will be sharing in the future growth of the corporation to some extent with the trust, the future capital gains tax responsibilities and probate fee responsibilities with respect to these growth shares cannot be determined at the time of the share reorganization.

Following the accomplishment of these two goals, estate freezing and probate value determination, the trust can then begin to benefit from the income splitting opportunities that have been created by virtue of the issuance of the non-voting common shares to it. Revenue Canada has indicated that where preferred shares are taken back as part of an estate freeze, provided the preferred shares are retractable (that is, redeemable at the option of the holder of the shares), to ensure the fair market value of the shares, there is no requirement that dividends be paid on the preferred shares. The operating corporation is thus free to pay all or any amount of its after tax income by way of dividends to the common shares issued to X, and/or to the common shares issued to the trust. Since the directors of the operating corporation will have the power, pursuant to the articles of amendment, to pay dividends to one class of common shares to the exclusion of the other or others, the directors of the operating corporation could declare that all of the dividends available from the operating corporation be payable to the trust. To the extent that the beneficiaries of the trust have no other income, the beneficiaries are able to receive approximately Twenty Thousand Dollars ($20,000.00) of dividends per person without the payment of any tax. Since a preferred beneficiary election will no longer be available after 1995, when the operating corporation pays dividends to the trust, it will be necessary for the trust to pass the dividend income onto the beneficiaries, or at least spend this money on their behalf, so that the dividend income will be included in the income of the beneficiaries, and not in the income of the trust, for tax purposes.

To the extent that X is already in the highest marginal tax bracket, and is in need of no further income, the allocation of all of the dividend income from the operating corporation may provide substantial economic benefits for the global family income of X. By way of example, if X has a spouse and four children who have no other income, they could receive, in total, approximately One Hundred Thousand Dollars ($100,000.00) of dividend income without the payment of any tax. X would have paid over Thirty-Seven Thousand Dollars ($37,000.00) in tax on this same amount of dividend income. The global family income is, enriched by Thirty-Seven Thousand Dollars ($37,000.00).

Since X, in the case of a partial estate freeze will be issued some of the new common shares of the operating corporation, X will be entitled to receive further dividend income flows from the operating corporation to the extent that X has need for his income.

As an alternative to the partial freeze, depending upon the economic condition of X, and the age of X, X may be willing to carry out a complete freeze of the operating corporation. In this case, X would not take back any of the new common shares of the operating corporation as part of the estate freeze transaction. Only the trust would be issued new common shares. X would be able to maintain control over the corporation by virtue of the retractability feature in the preferred shares taken back (because the exercise of call option by the holder could lead to economic disaster for the corporation), and by the receipt of a super-voting type of preferred shares, which would ensure that X could not be outvoted on any decision with respect to the operating of the operating corporation.

A further benefit to the trust from the ownership of the common shares of the operating corporation is that the growth of the operating corporation allocatable to the common shares held by the trust will give rise to a capital gain that accrues to the benefit of the trust's common shares. To the extent that the beneficiaries of the trust have available to them the Five Hundred Thousand Dollar ($500,000.00) capital gains exemption for qualifying small business corporation shares, the capital gains exemption otherwise available on the disposition of the shares of the operating corporation will be substantially multiplied. In practical terms, the capital gains exemption will be multiplied by the number of beneficiaries of the trust. If X were to have a spouse and four children who have not utilized their Five Hundred Thousand Dollar ($500,000.00) capital gains exemption, the capital gain exemption available to X's global family unit would increase from Five Hundred Thousand Dollars ($500,000.00), if X had still been the only shareholder of the operating corporation, to Three Million Dollars ($3,000,000.00) by virtue of the estate freeze that has been carried out. If X had been the only shareholder of the operating corporation, and had sold all the shares of the operating corporation for Three Million Dollars ($3,000,000.00), and had utilized an available Five Hundred Thousand Dollar ($500,000.00) capital gains exemption, an unprotected Two Million, Five Hundred Thousand Dollar ($2,500,000.00) capital gain would remain subject to tax. The tax burden for X in this situation would be approximately One Million Dollars ($1,000,000.00). If we assume X carries out an estate freeze when the operating corporation is worth Five Hundred Thousand Dollars ($500,000.00), and then does not take back any new common shares of the operating corporation after the freeze, but instead only the trust is issued new common shares of the operating corporation, a sale of all of the shares of the corporation at a subsequent time for Three Million Dollars ($3,000,000.00) would give rise to no tax liability. The effect of the estate freeze in this situation, would be to enrich the global after-tax family income of X's family unit by One Million Dollars ($1,000,000.00).

The estate freeze allows X to achieve some certainty with respect to future capital gains tax obligations and probate fee obligations, and in addition to carry out a form of reorganization which can result in X's family unit receiving tax-free dividend income that was otherwise unavailable to it, and receiving the benefit of tax free capital gains on a disposition of their shares of the operating corporation.

Spring 1999 -- Federal Budget Proposals Regarding Family Trusts

To date the attribution of income rules with respect to children have not functioned where the child was investing his/her own funds, thus permitting children to participate in the profits of an incorporated business of a parent. Most often, in cases where substantial amounts are involved, the inability of a minor to deal with his/her own affairs can create problems best resolved by creating a trust for the minor.

In the spring of 1999, the government decided that this was no longer appropriate, and has proposed an end to the current income splitting with minor children. From the year 2000 onwards, a special tax will be imposed on individuals who have not reached 18 years of age at the end of a taxation year. Certain income will be taxed at top marginal rates and not at the minor's ordinary tax rate, and includes:

(1) taxable dividends received directly or through a trust/partnership in respect of unlisted shares of a corporation
(2) amounts included in the minor's income as a shareholder benefit due to ownership of unlisted shares
(3) income from a partnership or trust derived from the provision of goods or services to a business carried on by
  a) a person related to the minor
  b) a corporation of which a related person is a specified shareholder
  c) a professional corporation of which a person related to the minor is a shareholder.

The tax will *not* apply

(1) to income arising from property inherited from a parent
(2) to income arising form any inherited property where the minor is a full-time post-secondary student, or is eligible for the disability tax credit
(3) during a taxation year in which the minor has no parent resident in Canada at any time in the taxation year.

A parent active in the business from which the income is derived will be jointly and severally liable for any tax liability of the minor child. This provision recognizes that collecting tax from children is problematic (legally, practically and politically).

Children who can perform legitimate employment activities can be remunerated by the corporation for the value of those services.

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Section 85 - Rollover

Transfer of property to corporation by shareholders. s.85 (1)(a),(b),(c) I.T.A.

(1) Where a taxpayer has, in a taxation year, disposed of any of the taxpayer's property that was eligible property to a taxable Canadian corporation for consideration that includes shares of the capital stock of the corporation, if the taxpayer and the corporation have jointly elected in prescribed form and in accordance with subsection (6), the following rules apply:

(a) the amount that the taxpayer and the corporation have agreed on in their election in respect of the property shall be deemed to be the taxpayer's proceeds of disposition of the property and the corporation's cost of the property;

(b) subject to paragraph (c), where the amount that the taxpayer and the corporation have agreed on in their election in respect of the property is less than the fair market value, at the time of the disposition, of the consideration therefor (other than any shares of the capital stock of the corporation or a right to receive any such shares) received by the taxpayer, the amount so agreed on shall, irrespective of the amount actually so agreed on by them, be deemed to be an amount equal to that fair market value;

(d) where the amount that the taxpayer and the corporation have agreed on in their election in respect of the property is greater than the fair market value, at the time of the disposition, of the property so disposed of, the amount so agreed on shall, irrespective of the amount actually so agreed on, be deemed to be an amount equal to that fair market value;

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Section 85 (1) Estate Freeze

An estate freeze also can be carried out by the use of a newly created holding corporation. In this situation, X transfers all of the common shares formerly held by X in the operating corporation to the newly created holding corporation. X receives as consideration for these common shares, fixed value, redeemable, retractable preferred shares of the holding corporation. These preferred shares are retractable for the fair market value of the common shares of the operating corporation at the date they are exchanged for the fixed value preferred shares of the holding corporation. An election is filed in accordance with subsection 85(1) of the *Income Tax Act* to defer any tax arising on the transfer of shares. Since all of the value of the operating corporation will be frozen by this transaction into the preferred shares of the holding corporation, the holding corporation can then issue new common shares to the trust and X for a nominal value. The only asset of the holding corporation at the time of the reorganization will be the common shares of the operating corporation. In the same manner as referred to earlier, for a Section 86 reorganization, the trust would pay for the common shares of the holding corporation that is has subscribed for with funds borrowed from an arms-length financial institution. The trust would borrow slightly more than the amount necessary to acquire the common shares of the holding corporation, in order to satisfy accruing interest obligations on the loan to the financial institution.

In the same fashion as utilized in Section 86 reorganization discussed earlier, the common shares of the new holding corporation would be of several classes, with both voting and non-voting classes. The various classes of common shares would be entitled to discretionary dividends, but the directors of the corporation would be entitled to pay dividends to one class of common shares, to the exclusion of the other classes.

At this point in time, X would elect as to whether a partial or complete freeze would be carried out. X could receive new voting common shares of the holding corporation, and receive a continuing dividend flow from the corporation and a portion of the future growth of the corporation, or X could decide to receive no common shares of the holding corporation, and allow all of the dividend income and growth of the operating corporation to flow up to the trust.

Since X has received fixed value retractable preference shares of the holding corporation, X will have determined with some certainty the value of the shares of the operating corporation to X's estate at the point in time of the reorganization. This will enable X to plan for capital gains tax obligations, and probate fee obligations with respect to the preference shares. If X elects to carry out a complete estate freeze, and not take back any common shares of the holding corporation, then X will have virtual certainty with respect to the impact of the value of the operating corporation on the value of the estate of X, since the shares X will hold after the reorganization will not increase in value.

If a partial estate freeze is carried out, X will maintain control over the operations of the operating corporation and the holding corporation by taking back voting common shares of the holding corporation. If X wishes to carry out a complete freeze, X will maintain control over the holding corporation and the operating corporation by virtue of the retractability feature of the preferred shares, and the receipt of super-voting preferred shares of the holding corporation.

Instead of the trust receiving dividends directly from the operating corporation, as discussed in the example where a reorganization is carried out under Section 86 of the *Income Tax Act*, the operating corporation will pay dividends on its common shares to the holding corporation. The holding corporation will then pay dividends on its common shares to it shareholders. The trust will use the first dividend received by it from the holding corporation to repay its loan obligation to the financial institution. The trust will also be permitted to declare and pay dividends in an amount approximately equal to Twenty Thousand Dollars ($20,000.00) per beneficiary, where such beneficiary has no other source of income, without the beneficiary paying any tax on such dividend income.

(However, see Spring 1999 Federal Budget Proposal above).

Since preferred beneficiary elections will no longer be available after 1995, it will be necessary for the trust to actually pay dividends received by it to the beneficiaries in order for such amounts to be included in the income of the beneficiaries and not in the income of the trust.

Provided the holding corporation has no other assets, save the common shares of the operating corporation, and provided the operating corporation is a qualifying small business corporation, the holding corporation will be a qualifying small business corporation for the purposes of the shareholders of the holding corporation being entitled to Five Hundred Thousand Dollar ($500,000.00) capital gains exemption.

Thus, by virtue of the reorganization carried out under subsection 85(1) of the *Income Tax Act,* the availability of the Five Hundred Thousand Dollar ($500,000.00) capital gains exemption will once again be multiplied by the number of beneficiaries of the trust that have the Five Hundred Thousand Dollar ($500,000.00) capital gains exemption available to them.

A section 85 freeze is, of course, not restricted to shares of an operating company. A taxpayer may transfer an investment portfolio, or an investment property, to a holding corporation pursuant to s.85 of the Income Tax Act.

The use of holding corporation will result in additional expense, being both from the cost of incorporation, and the cost of maintenance of the corporation. In certain circumstances the utilization of the holding corporation may be seen as the preferable route. Where a holding corporation is utilized, since the transfer of the assets by X to the holding corporation will be carried out utilizing the provisions of subsection 85(1) of the *Income Tax Act,* X may be permitted to "crystallize" any available capital gains exemption on the transfer of the assets to the holding corporation. This crystallization is available because X is permitted to elect the transfer price for the assets being transferred to the holding corporation. To the extent that X has available the Five Hundred Thousand Dollar ($500,000.00) capital gains exemption, and the assets being transferred in are shares of a small business corporation, X would elect that the transfer price, for the purposes of subsection 85(1) of the *Income Tax Act*, be the total of the existing adjusted cost base for the common shares of the operating corporation held by X, plus the available capital gains exemption for X. Since the capital gains exemption is being crystallized by virtue of this transaction, X will eliminate any fears that a subsequent budget may eliminate the capital gains exemption without X having derived the benefit of this exemption. If the assets being "frozen" are not shares of a small business corporation, X would generally elect at the cost price of the assets to defer any capital gains.

As stated, the trust will be obliged to pay any income received by it to the beneficiaries after 1995. In order for the trust's income to be taxed in the hands of the beneficiaries rather than in the trust, the trust may be permitted by virtue of the trust agreement to expend funds for the benefit of the beneficiaries, and to treat such expenditures as being amounts paid to the beneficiaries. While there is some concern by virtue of case law as to whether the payment of third party expenses for the benefit of the beneficiaries will be considered an amount paid to the beneficiaries, (see Langer Family Trust v. MNR below) it would appear that it is currently acceptable to Revenue Canada for such expenditures to be considered as amounts paid to the beneficiaries.

In *Langer Family Trust v. MNR*, the Ministry successfully disallowed a deduction to a trust for an amount paid by parent trustees for the benefit of the trust's three minor beneficiaries. The trust received dividends and interest of approximately $500,000 over a four year period. Other than the purchase of three $30,000 bonds and a few small payments of about $7,000, the trustees could not prove the trust had actually paid the amounts claimed to the children or to third parties for the children's benefit. The court suggested that even if adequate records had been kept, payments made by the trustees to third parties on behalf of the trust's child beneficiaries would not have been deductible. The court further suggested that amounts not paid directly to a beneficiary may not be deductible by a discretionary trust as a payment of trust income unless there was clear evidence that the beneficiary had directed the trustees to make such a payment to a third party.

Following the *Langer* decision, Revenue Canada stated that it considered the court's comments on third party payments to be *obiter* that would not influence the characterization of properly documented third party expense payments. In Revenue Canada's view, tuition fees, medical expenses, and other expenses incurred for a minor beneficiary's benefit would be considered income payable to the beneficiary. Furthermore, where a reimbursement of such payments is made to the beneficiary's parent because the beneficiary is a minor, Revenue Canada would still consider the income to have been paid to the minor.

Some Estate Planning Problems for Discussion

FACTS

Mom, dad and three children
Mom earns a salary of $150,000 and has significant investments
Dad earns a salary of $75,000
Children are ages: 19- attends University
12 and 14--attend private school and camp

Mom wants to do some estate freezing of her investments and income splitting of her investment income but retain control

1. Mom loans the investment assets to the children in exchange for a demand note
-74.1(2) attribution problem
-older child also has a potential attribution problem--56(4.1)--purpose test

2. Mom transfers the investment assets to a trust of which the three children are income beneficiaries and she is the capital beneficiary

   -74.1(2) attribution problem with respect to the 2 younger children
   -no 56(4.1) problem with respect to the oldest child since transaction was a transfer and not a loan
   -75(2) problem since Mom a capital beneficiary and therefore all income and capital gains will be attributed back to her and no property can be rolled out to anyone under 107(2)

3. Mom transfers investment assets to Holdco and takes back preference freeze shares; children's trust takes back common shares

   -74.4(2) will be triggered which deems an interest receipt to Mom of the value of the assets since the corporation is not a small business corporation and the purpose is to benefit a designated person
   -however if the trust provides that no one under the age of 18 can receive income or capital from the trust until he or she attains the age of 18, the children will not be designated persons and 74.4(2) will be avoided
   -this is an expensive option since income and capital gains will be taxed in the hands of the trust
   -this does not benefit the 2 younger children

4. Mom transfers her investment assets to a trust for the oldest child, which has an appropriate gift over clause to prevent child using *Saunders v. Vautier* to end the trust;
Mom is one of three trustees, a majority of whom must act;
no "wipe out" clause vesting assets back in Mom if there is total failure

   -no 74.1 problem since child is over 18
   -no 56(4.1) problem because the transaction was a transfer and not a loan
   -no 75(2) problem, even though the property could revert to Mom by operation of law, since it was not held by the trust on this condition